AUGUST 1960

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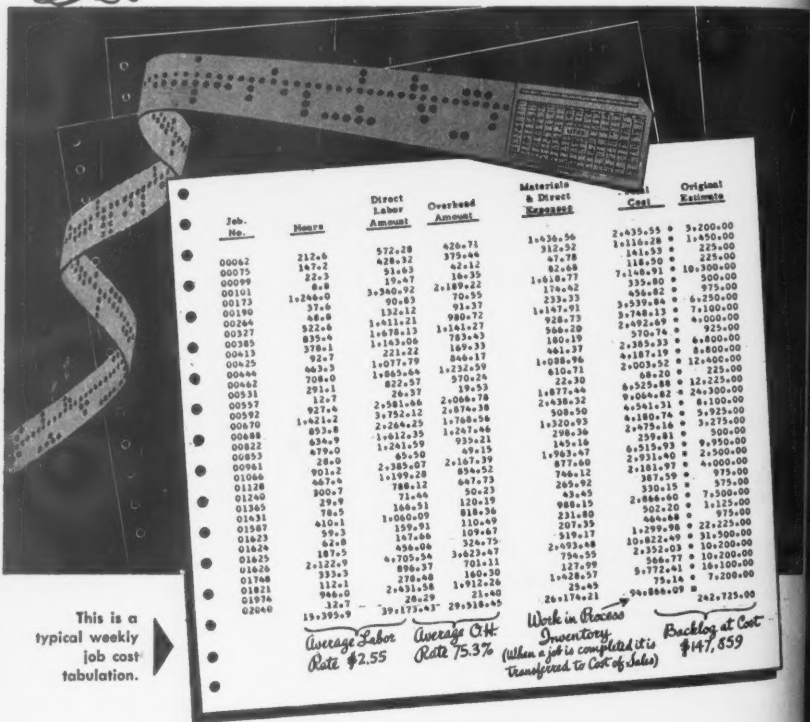

Job. No.	Hours	Direct Labor Amount	Overhead Amount	Materials & Direct Expenses	Total Cost	Original Estimate
00062	212.6	572.28	426.71	1.436.56	2.435.55	3.200.00
00075	147.2	428.32	375.44	312.52	1.116.28	1.450.00
00099	22.3	51.63	42.12	47.78	141.53	225.00
00101	8.8	19.47	16.35	82.68	118.50	225.00
00173	1.246.0	3.340.92	2.189.22	1.618.77	7.148.91	10.300.00
00190	37.6	90.83	70.55	174.42	335.80	500.00
00264	48.8	132.12	91.37	233.33	456.82	975.00
00327	522.6	1.411.21	980.72	1.147.91	3.539.84	6.250.00
00385	835.4	1.678.13	1.141.27	928.73	3.748.13	7.100.00
00413	378.1	1.143.06	783.43	566.28	2.492.69	4.000.00
00425	92.7	221.22	169.33	180.19	570.74	925.00
00444	463.3	1.077.79	846.17	461.37	2.385.33	6.800.00
00462	708.0	1.865.64	1.232.59	1.038.96	4.187.19	8.800.00
00531	291.1	822.57	570.24	610.71	2.003.52	12.400.00
00557	12.7	26.37	19.53	22.30	68.20	225.00
00592	927.4	2.581.66	2.066.78	1.877.44	6.525.88	12.225.00
00670	1.421.2	3.752.12	2.874.38	2.438.32	9.064.82	24.300.00
00688	853.8	2.264.25	1.768.56	508.50	4.541.31	8.100.00
00822	634.9	1.612.35	1.247.46	1.320.93	4.180.74	5.925.00
00853	479.0	1.241.59	935.21	298.36	2.475.16	3.275.00
00961	28.0	65.50	49.15	145.16	259.81	500.00
01066	901.2	2.385.07	2.167.39	1.963.47	6.515.93	9.950.00
01128	467.4	1.199.28	854.52	877.60	2.931.40	2.500.00
01240	300.7	788.12	647.73	746.12	2.181.97	4.000.00
01365	29.9	71.44	50.23	265.92	387.59	975.00
01431	78.5	166.51	120.19	43.45	330.15	575.00
01587	410.1	1.060.09	818.36	988.15	2.866.60	7.500.00
01623	59.3	159.91	110.49	231.80	502.20	1.125.00
01624	62.8	147.66	109.67	207.35	464.68	975.00
01625	187.5	456.06	324.75	519.17	1.299.98	22.225.00
01626	2.122.9	4.705.54	3.623.47	2.493.48	10.822.49	31.500.00
01748	333.3	896.37	701.11	754.55	2.352.03	10.200.00
01821	112.1	278.48	160.30	127.99	566.77	10.200.00
01976	946.0	2.431.58	1.912.26	1.428.57	5.772.41	16.100.00
02040	12.7	28.29	21.40	25.45	75.14	7.200.00
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$\underbrace{\text{Hours} \quad \text{Direct Labor Amount}}_{\text{Average Labor Rate \$2.55}}$

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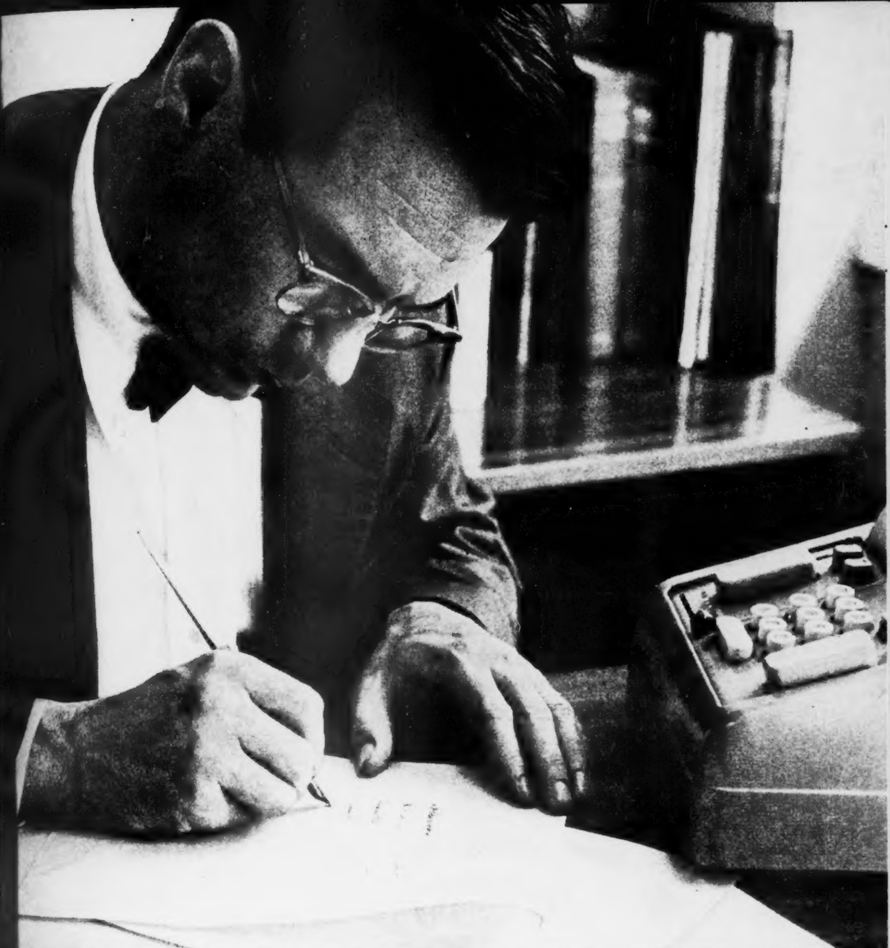

THE NEW YORK

Certified Public Accountant

August 1960 Volume XXX No. 8

CONTENTS

Accounting News And Trends

RECORDS RETENTION—REQUIREMENTS OF STATES IN THE U. S.

Vital assistance in coping with the problems of records retention is to be found in the Controllers Institute Research Foundation's 1,030-page publication "Corporate Records Retention, Volume 3, A Guide to Requirements of States in the U. S." (Price, $20; Vols. 1 and 2, covering U. S. Federal and Canadian requirements, $10 each.) The diversity of laws and regulations governing business in the 50 states makes records management a complex task for companies doing business in more than one state. This book gives access to the basic information which tells which records to retain and how long to retain them.

As one example, consider these requirements with respect to unemployment insurance records: In Alaska and Oregon, records of remuneration paid each employee must be kept for three years; Arizona, Delaware and 18 other states specify four years; 15 others require five; Kentucky, Michigan and New York say six, and ten states and the District of Columbia do not specify when such records may be destroyed.

The book classifies records retention requirements under the broad titles of Corporations General Taxation, and Labor and Industries. The first covers statutes of limitation, action on bonds, etc.; abandoned property; photographic or photostatic copies of records; the sale of securities, and records pertaining to stock sales and transfers, minutes of meetings, etc. The Labor category covers retention of records in regard to employers' liability, minimum wage standards, public works contractors, unemployment insurance and workmen's compensation.

Accounting News and Trends is conducted by CHARLES L. SAVAGE, CPA. He is presently serving as a member of our Society's Committee on Membership and is active in the National Association of Accountants. Dr. Savage is professor of accounting and chairman of the Business Administration Division of St. Francis College. He is also professor of taxation at the New York Law School.

CITY AUDIT CONTRACT

The fourth in a series of projects undertaken by the California Committee on Municipal Auditing, a joint committee of City financial officers and representatives of the California Society of CPAs, is a report entitled "Suggested Contents for City Audit Contract." (April 1960; price $1.00.)

As the title suggests, this 8-page booklet does not offer a model contract with specific provisions drafted in exact language, but rather sets forth the principal points which may be covered in the contract. One cannot help but agree with the statement of the committee that "the publication will assist cities in drafting a contract which will assure clear understanding between the city and the independent auditor."

As one item among many, we might consider the statements on fees. The booklet suggests no specific basis of compensation but lists the following as acceptable bases:

1. Fee based on rates and time (per diem basis) and expenses.

2. Fee to be the lesser of a stipulated maximum fee or as computed on a specified per diem basis (expenses may or may not be included in the maximum fee).

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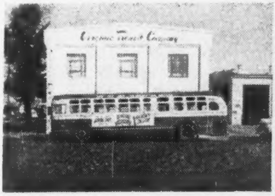
J. H. ARMSTRONG, Secretary - Treasurer, Virginia Transit Company.



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3. Fee to be the lesser of a stipulated maximum fee or as computed on a per diem basis regularly used by the auditor and not specified in the contract (expenses may or may not be included in the maximum fee).

4. Fixed fee specified in the contract (expenses may or may not be cluded in the maximum fee).

DISTRIBUTION OF LITERATURE AND UNPROFESSIONAL ADVERTISING

The AICPA Committee on Professional Ethics has issued the following opinion dealing with the distribution of literature (*The CPA*—AICPA monthly newsletter—May 1960):

[OPINION NO. 9]

There has come to the attention of the committee with increasing frequency printed material bearing a member's name and address or that of his firm, which is devoted either to informing others of the services the member or his firm is prepared to render or dealing with a specialized subject in a manner that might suggest the firm's ability to serve in a specialized field or geographical area.

The committee feels that such material is entirely proper when its distribution is carefully restricted to clients, but that failure to control the circulation of such literature directly or through third parties may place the member whose name it bears in

violation of Rule 10 of the Institute's rules of professional conduct prohibiting advertising.

The committee believes that a member who produces any literature, or material which may be considered promotional in nature, must assume responsibility to guard and control its distribution. It is recognized by the committee that in isolated cases a client, not knowing the profession's restrictions on the distribution of such material, may pass on to the client of another member material he found of interest. Such an isolated instance would not necessarily be viewed as unethical practice. Where there is evidence that reasonable control has not been maintained to limit distribution of such material, it is the view of the committee that it must, in the interest of the profession, strictly enforce both the spirit and the letter of Rule 10, which provides "A member shall not advertise his professional attainments or services. . . ."

[END OF QUOTED OPINION]

"SPECIAL ITEMS" ON THE INCOME STATEMENT

The "Accounting and Auditing Notes" department of *The Arthur Young Journal* (April 1960) offers some constructive thoughts on the use and abuse of *special items.*

The terms *special item, special charge* and *special credit* are frequently misused in financial statements. Their misuse arises out of failure to comply properly with Chapter 8 of Accounting Research Bulletin No. 43. Chapter 8 was originally issued in December 1947 as ARB No. 32 which established the ground rules for the exclusion of certain classes of items from the determination of net income and suggested the phrase *special items* as a generic term to describe amounts so excluded.

The bulletin is clear that any total which includes special items should not be described as net income. ARB No. 43 says: "Thus it is imperative that the caption of the final figure should precisely describe what it represents, e.g., *net income and special items, net income and refund of 1945 excess profits taxes, net loss and special items,* or *profit on sale of subsidiary less net loss.*" In spite of the clear language of the bulletin, the point is often missed, and financial statements are frequently noted which properly set forth and describe a special item and then identify the total which includes it as "net income," "net income including special item," "net income after special item," etc. According to ARB No. 43, ". . . the additions or deductions at the foot of the income statement after determination of net income are equivalent to direct credits or charges to earned surplus."

Another frequent practice is use of "special item," "special charge" or "special credit" to identify unusual items which are included (and properly included) within net income. This should be avoided since, in view of the meaning which has come to be associated with "special," it is undesirable to use it to describe an item which is included in arriving at net income.

Remember: (1) if it's a special item, the following figure is *not* net income (with or without qualification), and (2) if it is part of net income, don't call it a special item.

MUNICIPAL AUDITING ENGAGEMENTS AND CIVIC OBLIGATION

In *The Oregon CPA* (April 1960), President A. L. Platt of the Oregon Society of CPAs touches on an important problem facing that Society. He points out that the last Oregon legislative session, with the support of

the Oregon Society, passed a measure which greatly expanded the number of municipal bodies which will be annually audited by independent accountants listed on the municipal roster. This measure creates new opportunities for CPAs throughout Oregon to expand their practice.

The Society has received reports that certain municipal bodies are encountering reluctance on the part of CPAs to commit themselves to perform these annual audits. This situation may be caused by a lack of experience or knowledge of municipal auditing procedures. To remedy this defect, a special course on municipal auditing will be presented by the Municipal Auditing Committee of the Society. But the reason may lie deeper and Mr. Platt addresses himself to this point in the conclusion of an open letter to the membership:

"A further factor involved in this reluctance may be lack of appreciation by some CPAs of their obligation to the various governmental units to perform this work, even though it may not be as profitable as certain other parts of our practice. As professional men and women, and as citizens, we are obligated to see that competent accounting, auditing and budgeting is accomplished by local governmental units. We must look to ourselves for that competency."

ELECTRONIC DATA PROCESSING—SUBJECT BIBLIOGRAPHY

The management services research staff of Lybrand, Ross Bros. & Montgomery has prepared a report entitled "Electronic Data Processing—Subject Bibliography of Periodical Literature, 1959." Since the rapid acceptance of electronic data processing equipment has given rise to a corresponding growth in the writing on the subject, this excellent 49-page booklet serves the interested reader by listing articles appearing in some 75 periodicals.

Letters to the Editor

FINANCIAL STATEMENTS AND INFLATION

The March 1960 issue of *The New York Certified Public Accountant* contained an excellent article entitled "Financial Statements and Inflation," by Thomas G. Higgins, CPA, which reflected a scholarly approach to a very complex problem currently confronting the accounting profession. Considering that the issues raised therein sometimes generate more heat than light, Mr. Higgins' objectivity is all the more remarkable. The article is a most fair presentation of the arguments pro and con which have been advanced over the past ten to fifteen years, relative to the effect of changing price levels upon the determination of net income and to the desirability of adjusting financial statements for the effects of inflation in order to make them more meaningful. I believe that the accounting dilemma discussed by the author requires the thoughtful reflection of all segments of the accounting profession and not only the participants in the research program of the American Institute of CPAs. It is in this spirit, based upon long reflection and currently stimulated by the reading of Mr. Higgins' article, that I am submitting this "letter to the editor" as a vehicle for the expression of some of my thoughts on certain facets of the problem.

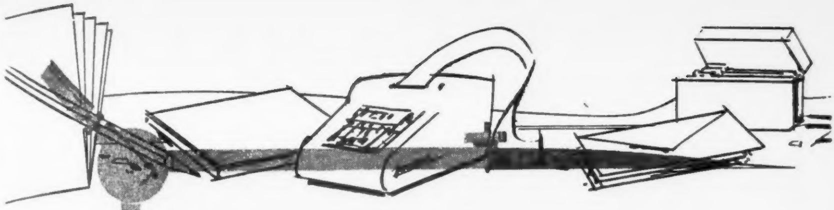
For myself, I believe that no special tax relief should be accorded to companies with substantial investments in fixed plant and equipment, the entities for whom the plea is made so frequently and extensively during periods of rapidly rising price levels. I disagree with the orientation of the study *Price-Level Changes and Financial Statements—Basic Concepts and Methods,* which states: ". . . evidence will be obtained that income taxes are now based upon a concept of income which is questionable and which, in particular, discriminates against companies with large investments in plant and equipment when the price level is rising . . ."

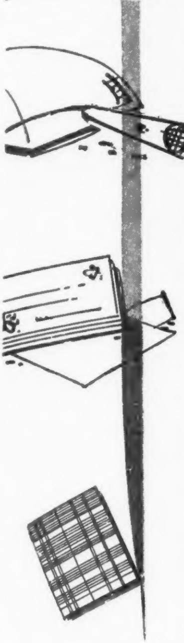
I do not find any extensive dearth of replacement capital funds on the part of these "companies with large investments in plant and equipment." On the contrary, we find that these entities have been able to provide for their perpetuation and phenomenal expansion with a most insignificant call for new equity financing. Thus, from the September 1957 issue of *Current Business* (page 8):

"Three-fifths of all capital funds used by corporate business in the postwar period has been derived from internal sources, i.e., retained earnings and depreciation allowances. An additional one-fifth has been raised in long-term markets, with debt issues predominating, while the remainder has involved increases in short-term debt, principally accounts payable and bank debt."

Commenting on the preceding paragraph, A. A. Berle, Jr., in his book *Power Without Property* (page 39), states:

"Manufacturing and mining during this decade [1947-1956] got an inflow of $173.3 billion of capital and devoted $109.9 billion to plant and equipment. These enterprises increased their inventories by $29 billion, their accounts receivable by $23 billion, and their liquid and other assets by





$10.9 billion. But they had got their $173 billion by retaining in the companies $58 billion of profits, by earning $52.2 billion by depreciation, by raising $24.6 billion of money through long-term debt—$24.5 billion chiefly by borrowing from the banks—and by issuing stock (risk capital) amounting to $3.2 billion."

It is clear, then, that there has been an almost negligible requirement for new shareholder-equity financing on the part of those entities for whom the appeal for special relief is so generally made. This almost negligible recourse to new equity financing has been most disproportionately less than the expansion in the revenues and scope of activities of the entities involved.

Suggesting another dimension to the foregoing, the December 15, 1959 issue of *Forbes Magazine* states:

"You hear much about the 'demand for shares,' but most commentators seldom mention the 'supply of shares,' except when the market is going down.

Actually, supply always is just as important as demand—because you can't make a price unless someone sells to someone who buys. Large blocks of good stocks have been taken out of the market by institutions, pension funds, mutual funds and capital-gains-tax-conscious individuals who do not sell. Corporations have been needing less new money from the sale of new stock issues because of larger amounts of self-generated cash, obtained through retained earnings and larger depreciation.

"Aside from utilities, hardly a single really big corporation has been financed through the sale of additional shares in 1959. Most of the new stock issues have been comparatively small, and not by leading companies."

So it is that I find it incongruous that pleadings for special relief are being made in behalf of the very companies which are already adequately insulated from the pernicious effects of inflation. This insulation stems from the fact that these very entities have demonstrated their ability to compensate for increasing price levels through, in turn, increasing their prices to the consumer.

Would not the proponents of special depreciation deductions (and resultant tax reductions) lead our economy further on the road to an inflationary spiral (and, on the rebound, help to accelerate a deflationary trend)? The result of their special pleas would be a reduction in taxes during periods of rising price levels, with a compensating increase in taxes in periods of declining price levels. This is, if anything, inverted logic; students of progressive taxation would certainly urge that taxes should be increased with rising price levels (to withdraw purchasing power from the market place); and the converse during periods of declining prices.

If there is any tax relief to be meted out by reason of the effects of inflation, should it not be to the bondholders, insurance policy beneficiaries, annuitants, pensioners, and the like. By way of pointing up the question, the First National City Bank's *Monthly Letter* for May 1956 states: ". . . people who bought savings bonds and held them for a ten-year term have found that interest received has been insufficient to compensate for income tax payable and the 'inflation tax' levied in the form of a shrinkage in the buying power of the dollar." The letter then sets forth data to show that if an E bond were bought in 1945 and matured in 1955, and if the increment were taxed at the lowest rate then in effect (20 percent), a $100 maturity value would give rise to a $5 tax on the $25 increment, leaving $95 net of taxes. Inasmuch as there had been a 43.5 percent increase in price levels during the 1945-1955 decade, the $95 received in 1955 is stated to be the equivalent of but $66.20 in 1945 dollars. There is thus shown to have occurred a "real" loss of $8.80 on the original investment, or an average loss of 1.17 percent per annum.

As between companies with large investments in plant and equipment and the individual with investments in insurance policies, savings bonds, annuities, etc., would it not appear that it is those in the latter group who should be the primary object of tax relief (if such relief should be considered feasible) when price levels are in the ascendancy? The group which is heavily endowed with plant and equipment will probably find that it will generate even greater revenues by reason of the price level increase, whereas the annuitants and others in that group are not similarly situated.

I am confident that it can be demonstrated that, during this very decade when the E bondholder had been suffering an average "real" loss of 1.17 percent per annum, those who invested

in the stocks of these entities having substantial investments in plant and equipment, had reaped a veritable financial harvest. This harvest becomes even more bountiful by the realization that the equity investor's gains are, in part, insulated from taxation by the application of the dividend-received credit, advantageous capital gains rates, etc. Granted that the yield to the risk-taker should not be resented, but does that mean that all the other parties (including the E bondholder, annuitant, etc.) should sustain an even greater tax burden in order to increase further the former's rewards?

ABRAHAM J. BRILOFF, CPA
New York, N. Y.

EMPLOYEE BENEFIT PLANS

BIBLIOGRAPHY OF ACCOUNTING AND AUDITING LITERATURE

A great deal has been written and published in recent years on the subject of "Employee Benefit Plans." Most of this material deals with such matters as: advantages of "fringe benefits" as compared with direct wage or salary increase; statistics showing growth in the number of existing plans or in the amount of their invested assets; and tax consequences to the contributing employer or the employee beneficiary. Very little, however, has been published dealing with the accounting and auditing problems of employee benefit funds operating as distinct entities.

Many funded employee benefit plans are required by statute to operate as independent trusts. Others do so to obtain important tax advantages. Still others do so for administrative and management purposes. Whatever the reasons, the number of such entities is growing rapidly. As a result, more and more accounting practitioners are being called on by such funds for accounting and auditing services. In many instances, such practitioners, without previous experience in the field, have been faced with problems which they could not readily answer and yet have been at a loss as to where to obtain assistance which might be found by reference to published material.

Accordingly, the Committee on Employee Benefit Plans of the New York State Society of Certified Public Accountants recognized the need for compiling a bibliography of available literature dealing primarily or significantly with the accounting and auditing aspects of the subject. A sub-committee was appointed for this purpose, consisting of Alvin J. Mentzel, CPA and Willard R. Schiller, CPA, through whose devoted efforts the following bibliography was made possible. Although recognizing the possibility of unintentional omission, it is believed that this comprehensive listing is reasonably complete and that it will be of assistance to your readers.

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ISIDORE PLATKIN, CPA
(Tunick & Platkin)
Chairman, Committee on
Employee Benefit Plans
New York, N. Y.

Book Reviews

HANDBOOK OF ANNOTATED FORMS FOR TAX PRACTICE

By Sidney I. Roberts, Samuel Schultz, Gerhard Mayer. PRENTICE-HALL, INC., Englewood Cliffs, N. J., 1959. Pages: xxvi + 725; $24.95.

Practitioners faced with the problem of preparing or completing one or more of the numerous forms required in tax practice can generally save both effort and time if they can refer to a similar form previously used. Whether the form be a simple certificate in support of exemption for the blind, a statement of liquidation under IRC Section 337 or even a brief to be presented to the Tax Court, reference to a previously prepared applicable form can be of great value.

The *Handbook of Annotated Forms for Tax Practice* is a volume in which these and literally more than two hundred other statements, elections, applications, claims, notices, powers of attorney, affidavits and various other forms encountered daily by the tax practitioner are to be found. A rundown of the chapter headings will give a general idea of the wide variety of forms included: forms filed with income tax returns; forms relating to filing returns and paying of tax; to personal holding companies; to accounting methods and taxable years; to nontaxable exchanges of property; to estates and trusts; to foreign persons and foreign transactions; powers of attorney and related forms; forms relating to conference procedure before the Internal Revenue Service; to practice before the Tax Court; claims for refund; captions, jurisdictional allegations and signatures and miscellaneous forms.

In addition to illustrating the form itself, the authors follow each example with comments containing an explanation of the form, pertinent references to the Code, regulations, cases and rulings, bibliographies when considered desirable, as well as many valuable practical suggestions. These comments are designed to minimize research time necessary for appropriate use of the form. A well-prepared twenty-three page index is of great assistance to the reader.

This handbook is, in my opinion, a valuable addition to the library of the experienced tax practitioner and an invaluable one for the less experienced accountant.

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READINGS IN AUDITING

By James T. Johnson and J. Herman Brasseaux. SOUTH-WESTERN PUBLISHING COMPANY, Cincinnati, Ohio, 1960. Pages: x + 658; $6.50.

The continuing vigor of a profession may be partly judged by the quality and the amount of periodical literature generated by the profession for the benefit of its members. That our profession meets this measure of lively growth is quite evident from the number and nature of the articles that have appeared during the last ten years. One of the further landmarks of success is reached when such articles reappear between the covers of an anthology. Several collections of both reprinted articles and original papers have recently appeared and the present book of readings in auditing is an excellent addition to the list.

The editors have very carefully selected some of the best papers that have been published in the last decade in our various accounting journals which center around the general topic

of auditing. Professors Johnson and Brasseaux have furthermore succeeded in avoiding the disjointed fragmentation which so often besets anthologies. This book gives the reader a feeling of continuity as he goes from one article to another. The editors have accomplished this by grouping articles under functional topics and by providing sufficient and cogent editorial comment to bridge one section with another. In addition to the standard topics covered (Internal Control, Ethics, Standards, Legal Responsibility, etc.), it was gratifying to see readings on such recent developments as Statistical Sampling, Auditing Electronic Machine Records, and Management Advisory Services.

This is a very worthwhile book for students, practitioners, and professional libraries to own. Most readers will not only find many articles which are new to them but will, like this reviewer, experience the delight of rereading some outstanding papers which stand the acid test of re-perusal very well. Readers of this magazine will be particularly pleased to note that eighteen of the sixty-one articles in the book originally appeared in *The New York Certified Public Accountant.* This is no small tribute to the authors and to the past and present editors, Dean Emanuel Saxe and Professor Benjamin Newman, who have given such generous service to our profession.

A supplementary bibliography, classified under the same topic headings as the readings, is included to help the interested researcher easily locate additional material. In the list of one hundred and fifty-three articles, *The New York Certified Public Accountant* is again well represented by thirty-two articles.

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THE PRESIDENT'S PAGE

The New Rules of Professional Conduct

After exposure both to the Board of Directors of our Society and at the general meeting held on April 21, 1960, the new rules of professional conduct were submitted to the membership for a mail ballot on May 31, 1960. The new rules were all approved and are now in effect. The results of the ballot are tabulated below.

The adoption of the new rules is a major step forward and another milestone in the annals of the accounting profession. Wherever possible and practicable, the rules conform in substance, language and number to those of the American Institute of Certified Public Accountants. A word of comment may be in order regarding the revision of three of the rules which received the largest number of negative votes.

New Rule 7 bans encroachment upon the practice of another public accountant. It also provides that a member shall not agree to perform any services for a client of another public accountant without first notifying such accountant. This is a courtesy, with numerous practical and desirable advantages, which has been followed by many members even before the adoption of the rule.

New Rule 10 in substance prohibits advertising and eliminates many irritating situations. It conforms to the recently amended AICPA Rule 10.

New Rule 13 emphasizes the independent character of the CPA. In substance it requires disclosure if the certifying accountant is an employee or director of his client or has a financial interest therein. Consideration will be given to a revision of the rule after the AICPA membership expresses itself later this year on a pro-

posed new rule which, in effect, would bar the certifying accountant from owning any securities of his client or being connected with his client as director, employee, etc.

With the adoption of these new rules of professional conduct, the New York State Society of CPAs has again blazed the trail, and the CPA profession in New York can be truly said to have come of age in maturity and understanding. Deserving of particular commendation for their tireless labors in developing and perfecting the new rules, are Edward F. McCormack and the late Frederick W. Wulfing who served as chairmen of the Committee on Professional Conduct during the course of this project which extended over a four-year period. And these sentiments apply as well to the members of their committee whose valuable contributions contributed so significantly to the successful consummation of the project. We are also particularly grateful to our immediate Past President, Thomas G. Higgins, who gave the committee the benefit of his experience as Chairman of the AICPA Committee on Professional Ethics, on which he has been serving for many years.

The Society's Committee on Professional Conduct stands ready to assist members in the interpretation of the rules. Wherever necessary, statements on the subject will be published. It is hoped that infractions will be avoided and that the Society's Trial Board will not have undue activity in exercising its authority under the bylaws when violations make it necessary to bring cases to its attention.

BENJAMIN GRUND,
President

TABULATION OF THE VOTE

Affirmative on the entire revision	2,148
Negative on the entire revision	11
Number voting separately on each rule	534

COMBINED TABULATION

Rule	Yes	No		Rule	Yes	No
1	2,676	14		12	2,673	17
2	2,675	14		13	2,590	97
3	2,642	47		14	2,661	27
4	2,621	68		15	2,644	45
5	2,654	35		16	2,674	15
6	2,673	17		17	2,658	30
7	2,271	419		18	2,649	39
8	2,622	66		19	2,651	36
9	2,622	66		20	2,653	36
10	2,548	142		21	2,656	30
11	2,666	25	(deletion of old Rule 16)		2,625	57

Operations Research Applied to Business Problems

By DAVID B. HERTZ

Operations research can assist management by developing systematic means to provide logically related facts so that the opportunity will exist to make better decisions. This article describes the areas in which all businesses may be able to utilize operations research, and presents several case studies which may serve the practicing accountant as helpful examples in the practical application of operations research in dealing with certain problems with which he is familiar.

INTRODUCTION

INDUSTRIAL operations research may be defined as the study of costs and revenues which are likely to result from various alternative decisions in uncertain or complex business situations. The purpose of such studies is to develop systematic procedures which will provide business executives with effective information to assist them in making the decisions which guide and control their enterprises.

Accountants are, of course, immersed in the study of costs and revenues and in developing projections of future costs and revenues, based on assumptions provided by management. However, it is not the task of operations research to develop similar projections, but rather to study and analyze the costs and revenues involved in such a way as to discern (1) significant alternative decisions, and (2) logical relations among the factors inherent in the specific business problem. From an understanding of the decision alternatives and the logical relationships, the operations research scientist tries to develop *information systems* which will give management useful bases for making choices among specific alternatives. The design of such systems requires an appreciation of the risks which attach to all business decisions, as well as an understanding of mathematical ways to fit together complex relationships among various factors. The operations researcher must also be prepared to test the systems and to implement them in the industrial environment.

Because the uncertainties or risks must be combined with implementation as well as with mathematical understanding, operations research is by no means equivalent to mathematics, statistics, or even so-called mathematical programming for business. A comprehensive knowledge of such subjects is, however, essential for the professional

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operations research worker. Operations research avails itself of these and other methods of science to state formally the relationships among variables. Many discussions of the subject revolve around such topics as *linear programming*, *queuing theory*, *theory of games*, *dynamic programming*, *Monte Carlo procedures*, and so on. These techniques all have a bearing on modern operations research, but to describe the field to the uninitiated primarily in these terms has always seemed to me an approach that misses the main issues. Operations research is beginning to be widely used in industry; the reasons for its use and the business problems in which it is used are the most important and interesting areas on which light should be shed for the non-professional. Further, examples of business problems which are related to his experience and which in themselves teach useful lessons are perhaps more important than examples of techniques.

It is to demonstrate those areas in which *all* businesses may be able to utilize operations research and to develop some examples which may serve the practicing accountant as helpful examples in some problems with which he is familiar, that this article has been written. The concepts and cases described have been distilled out of several years of operations research experience in public accounting.

O.R. AREAS CONTRIBUTING TO EFFECTIVE MANAGEMENT

The business executive in every enterprise, large or small, in light or heavy industry, faces many problems requiring decision. To effectively make decisions, he requires information in a number of areas. These areas are virtually the same (although the decision alternatives may not be) in *every* business. Operations research can assist management by developing systematic means to provide logically related financial facts so that the opportunity will exist to make better decisions. "Opportunity" is used advisedly, since operations research cannot *manage* or *replace* the business man's judgment, but only establish the useful facts in a logical manner.

The following discussion describes the areas in which all business managements require information (whether systematic or intuitive, whether right or wrong, they still all must have some "view" of each of the following in order to carry on their work), and in which operations research has demonstrated its ability to help.

Long-range forecasting. Every business must look to the long-range future, either actively or by default. The business man bases decisions as to replacement policies, expansion, product development, research, etc., in part, at least, upon the long-range forecast. Forecasts are uncertain by nature; the explicit nature and import of the uncertainties can be laid bare by the systematic procedures of operations research.

Short-range forecasting. Systems to characterize the likelihood of specific events occurring, are part and parcel of almost all every-day operations in business. These systems may be "top of the head" or "seat of the pants," but management uses them to decide on such questions as production, inventory, purchasing, and pricing. Procedures providing information to assist in making judgments in the face of uncertainty are involved in almost all so-called inventory, stock, and waiting-line problems of operations research. Making explicit the consequences of the uncertainty is again a key ingredient in such systems, as we shall attempt to illustrate in an example later on.

Cost determinations and cost analyses. Knowledge of costs is generally accepted by business men as one requirement for good management decision. Determination of adequate cost information can be a complex and intricate task. There are uncertainties also in such determinations. The approach and methods of

operations research can provide techniques which are logical and helpful in making the determinations and which indicate the kinds of errors and uncertainties which are a natural part of the variations inherent in industrial and commercial operations. An example of the use of mathematical techniques to assist in cost determination and analysis will be discussed below.

The balancing of resources and facilities. Bottlenecks slowing or stopping production, idle equipment, excess personnel, and inadequate service facilities are symptoms of imbalance. In complex situations (e. g., many machines or alternate resources; many products or alternate demands), management may develop efficient allocation without effective systematic procedures, but usually only after long periods of trial and error. Operations research offers a number of approaches to aid decision-makers in these cases, such as linear programming, dynamic programming, and queuing theory, among others. From the business man's point of view, the utility of a particular solution will depend directly on its capacity for exposing the interrelationships of the factors involved and its possibilities of being implemented in the actual situation. Proper balancing thus requires knowledge of costs as well as forecasts of what is likely to happen.

Activity sequencing. Closely related to balancing of resources is activity sequencing—another area in which all managements must make decisions, and in which, therefore, they require information. Decisions must be made as to what to do, when to do it (and in what order), and information as to what was done and when must be returned for the next cycle of decision. Again, for efficiency, this area of information should be set against information about balance of facilities, allocation of resources, cost forecasts, and magnitude of uncertainties. Techniques of simulation (i. e., "operating" facilities on "paper" using various rules) can be utilized to provide information about likely cost and revenue consequences.

Resource acquisition. Every business must acquire resources—raw material, equipment, personnel, etc. The manner in which this is done affects profits and returns on investment. The approaches of operations research may be utilized to furnish management with information which will permit decisions to be made with effective data on hand. Clearly, knowledge of costs, forecasts, and scheduling is necessary if such methods are to be efficient.

Performance evaluation. Linking all of the areas described, the executive must somehow decide whether what was done was effective, and he must evaluate performance throughout the enterprise in terms of objective standards. To logically establish such standards in a systematic manner requires knowledge of the possible (i. e., forecasts, balancing and scheduling methods, resource acquisition). Operations research has the tools to put together such performance evaluations for individual departments and for the business as a whole.

None of the above can be done either in a vacuum or single-handedly by any one approach. There must be joint efforts of executives, accountants, methods and procedures personnel, data processors, and others, along with the operations research scientists, if the tasks which *can* be accomplished are *actually* to get done.*

* The reader who wishes to gain a deeper and more technical knowledge of operations research may find helpful the following selected references: Moroney, M., *Facts From Figures*, Penguin Books, Baltimore, 1956; Sasieni, M. W., Yaspan, Arthur, and Friedman, Laurence, *Operations Research: Methods and Problems*, John Wiley & Sons, Inc., 1958; Vazsonyi, Andrew, *Mathematical Programming for Business and Industry*, John Wiley & Sons, Inc., 1958; Miller, David W. and Starr, Martin K., *Operations Research and Executive Decisions*, Prentice-Hall, New York, 1960; Churchman, C. W., Ackoff, R. L., and Arnoff, E. L., *Introduction to Operations Research*, John Wiley & Sons, Inc., 1958.

To illustrate the use of the approaches mentioned in problem areas of interest to accountants, two examples will be discussed. The first will describe the use of statistical methods in providing balanced inventories in a complex production-distribution system. The second will outline some ways of utilizing mathematical methods in cost determination and analysis.

USE OF OPERATIONS RESEARCH IN AN INVENTORY PROBLEM

When a retailer orders goods from a manufacturer's distributor, he expects to receive immediate shipment. What is immediate shipment? Let us say that it means shipment off the shelf or within twenty-four hours. If the order is unusually large it may mean partial shipment immediately, with the remainder within a few days. These conditions are then descriptive of "desirable customer service."

For a given price and quality of product, the customer will often favor the manufacturer whose distributors offer the best service. This permits the customer to provide good service to his own customers with a minimum investment in inventory of his own. Expeditious filling of orders at all levels is an accepted requirement of successful industrial operation. How is "desirable" service achieved?

One obvious rule of good service is that in order to serve, you must have. Hence, the manufacturer must have the items available for shipment both from his own stocks and those of his distributors. This seems to suggest quite a simple goal: just manufacture and have the required item on hand. But, can this be done under all circumstances? Or, rather, can this be done profitably? For example, suppose that there is a particular type of item for which there are three orders per year—some years the average order is for 1,300 units, whereas in others it has been as high as 10,000 units. In some years all orders have come in during the same week. What does the manufacturer do? Should he make 30,000 units each year and store them in three different warehouses? One further consideration before we answer: there are, say, 600 distinct items in this category. Should he make and store 18,000,000 units of product to be able to offer good customer service? If each unit costs a dollar, this means tying up $18,000,000 in inventory to be able to provide good customer service. If we operate with only $9,000,000 in inventory we are likely to be frequently out of stock and must do a good part of our business on a back-order basis. Is this a better policy? Will our customers tolerate it? Let us now examine the problem in a more systematic way, using the approach and methods of operations research.

Our task is to formulate this problem so as to yield an answer which sets inventory levels and determines costs required to provide and maintain desired customer service. In order to describe the problem properly, we must specify the manufacturing-distribution system, the associated costs and lead-times, and means for management to control the level of customer service. Then we may be able to develop a calculation procedure, based on past and current sales, various applicable costs, lead-times, and a control variable which management can use to set service levels. The resulting procedure may then be used to set inventory levels, by item, at every point where service is provided.

The best way to illustrate the principles involved is to work out the details of a specific example for a single-product line.

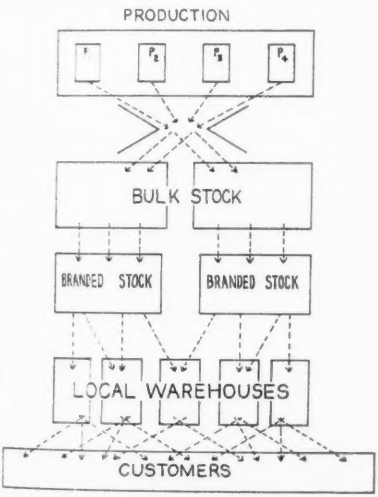
THE PRODUCT LINE

Company X manufactures a product line comprising 800 distinct items, which are not interchangeable. It produces in large quantities and has a nationwide distribution system. In order to facilitate distribution and offer local service,

Company X has a multi-stage warehousing system illustrated in Figure I. Product from the manufacturing process goes to one of two bulk stocks, one kept in the eastern part of the country, and the other in the west. When these items have been branded with various customer names they are transferred to branded stock and held at the same location as the bulk stocks. Stock is not committed by branding except upon demand.

FIGURE I

FACTORY MULTI-STAGE WAREHOUSE LINKAGE SYSTEM



Items are shipped from branded stock to meet the demands of local warehouses. (The number and location of local warehouses is another part of the operations research problem that we shall not consider here.) Generally, demands by the local warehouses in the west are filled from the western branded stock; similarly, eastern local warehouses are filled from the eastern branded stock. Figure II illustrates the flow of a specific item through the distribution system. It shows customer demand for 150 units of item AD-9 at the local warehouse, which in turn calls on branded stocks at the main warehouse; there it is replenished from bulk stocks, which in their turn are kept filled by the factory.

What we must have to solve this management problem is a policy which provides action criteria for the integrated operation of the multi-stage system. We must, therefore, know the mechanics of movement of items:

Starting at the local warehouse level, the customer (usually a retail store) places an order for a specific item with the local warehouse. The local warehouse fills the order on demand. When the local warehouse stocks fall below a certain point, an order for a quantity of this item is placed against the branded stock in, say, the eastern warehouse. Remember that the branded stock must support the demands of all the eastern local warehouses. When the branded stock of this item falls below a certain level, an order is placed for a quantity of bulk stock to be branded. Similarly, when the bulk stock of this item drops below a specified level, an order for a quantity of this item is placed with the production department. There are various lead-times which apply in obtaining an order from the next higher stage in the system. At all levels except the orders against production, the lead-time is only a few days—essentially the shipping plus handling time. The production lead-time averages about 42 days.

In order to gauge the complexity and importance of the problem of inventory policy, we must remember that there are some 600 distinct bulk items; that there are about 800 non-interchangeable items in the branded stock.

FORMALIZATION OF THE SYSTEM

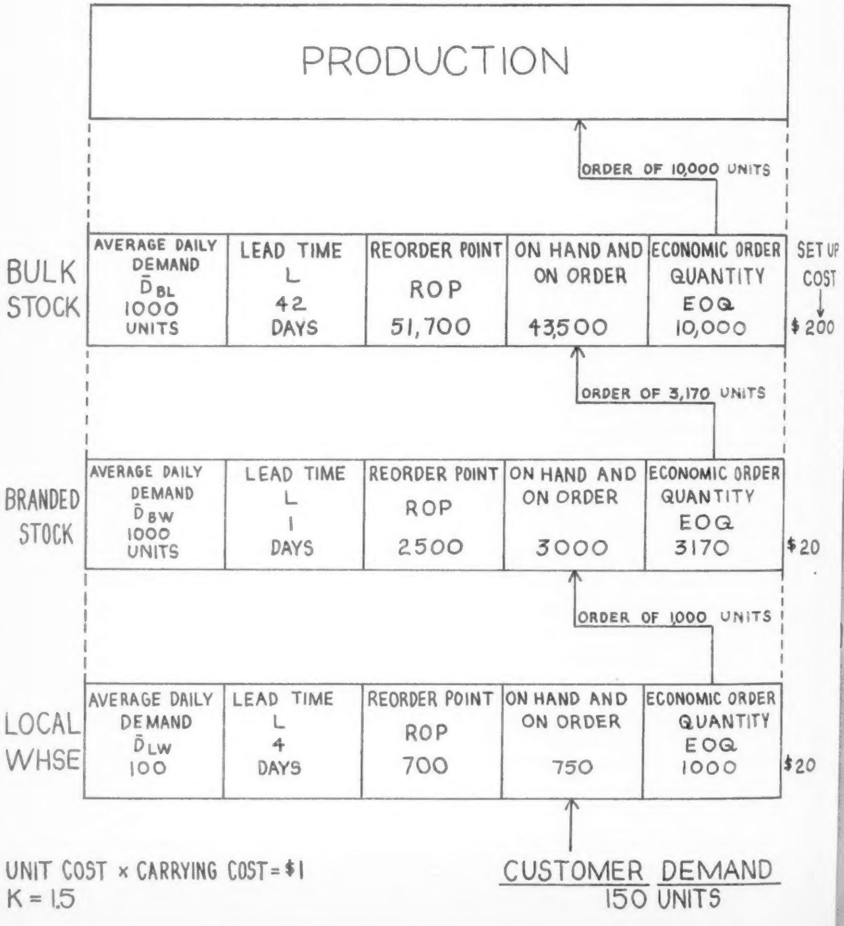
We must study all the variables which influence the behavior of the stock of an item in the multi-stage production warehouse linkage. There is, of course, the daily demand (call it D) for a given item,

which is a random variable (that is, we cannot tell in advance precisely what it will be on a given day). We must estimate the value of the demand at each level of the system. If we have reason to believe that future demand will behave consistently with past demand, it is reasonable to treat D as a random variable with an average and a standard deviation around that average that can be determined from actual values of D from the near past. (Standard deviation is a means of describing the variation of the actual values around the average; see below.) Study of D might indicate, for example, that D has approximately certain *specific* and stable *statistical* characteristics. These characteristics permit us to measure the standard deviation (which is that deviation from the average

FIGURE II

MULTI-STAGE INVENTORY FLOW

ITEM: TYPE AD-9



in which about 34 percent of the daily demands may be expected to fall). If we do this we may find, for example, that the average daily demand is $\bar{D}$ and the standard deviation is $\sqrt{\bar{D}}$. $\bar{D}$ can be perhaps forecast from some running average. In the present case, let us say we have found a six-month running average updated monthly as proper for our short-range forecast.

The kind of inventory policy developed is intended to give those in control of inventory and production policy criteria on *when* to order a specific item and on *how much* to order.

The "when" is triggered by the level of the inventory commitment (that is, the amount on hand or on order) of a particular stock at any time of review. The inventory commitment at time of reorder is designed to be enough to provide desired customer service while awaiting the arrival of that particular reorder. Thus we must consider the lead-time demand, that is, the amount which we expect to sell while awaiting the arrival of the last reorder. The lead-time demand is related to both the daily demand D and the lead-time. The lead-time (L) is also a random variable, and study may show it also has specific and stable statistical characteristics, such as average $\bar{L}$ and standard deviation $\sqrt{\bar{L}}$. The lead-time L and demand D are generally independent (that is, one does not depend upon the other), which *simplifies* the formulation of the lead-time demand. In outlining the procedure for a proper multi-stage control policy, we shall state the rules but will not go through the mathematical development. We will, however, indicate the statistical plausibility of the rules.

DETERMINING THE REORDER POINT

How do we determine the reorder point (*ROP*), that is, the level of inventory commitment at which to issue an order? For example, if a certain local warehouse can expect delivery from the branded stock in about three days, then the local warehouse must always have at least a three-day supply on hand (or in transit) from the branded stock, namely the average demand times the average lead-time, $\bar{L} \cdot \bar{D} = 3\,\bar{D}$. But L and D are random variables which means that more (or less) than $\bar{D}$ may be demanded in any one day and that the delivery of an order from the next higher level may take more (or less) than $\bar{L}$ days. If we have a commitment of only $\bar{L} \cdot \bar{D}$ we meet the long-term demand but often only on a back-order basis which most of our customers will find to be not acceptable. To get a better idea of how much the lead-time demand can vary, we shall use the standard deviation of the lead-time demand. In particular, the average lead-time demand is $\bar{L} \cdot \bar{D}$; the standard deviation of lead-time demand is $\sqrt{\bar{L}}\,\sqrt{\bar{D}\,(\bar{D}+1)}$. If we set the commitment at

$$\bar{L} \cdot \bar{D} + 2\sqrt{\bar{L}}\,\sqrt{\bar{D}\,(\bar{D}+1)},$$

that is meeting the mean lead-time demand plus 2 standard deviations, this will take care of the demand about 98 percent of the time. However, it is more useful to represent the reorder point as:

$$ROP = \bar{L}\,\bar{D} + K\sqrt{\bar{L}}\,\sqrt{\bar{D}\,(\bar{D}+1)}$$

where K is the number of standard deviations of safety stock provided as a hedge against stockout. *K is the key management control in the system*, and will be discussed in greater detail later.

Consider the following example: At a given warehouse, one item has historically an average demand $\bar{D}_1 = 100$ units per day, and a second item has an average demand $\bar{D}_2 = 400$ units per day. Assume the average order lead-time from the next higher stage is $\bar{L} = 4$ days. Calculate the reorder point for, say, $K = 1.5$.

$$\begin{aligned} ROP_1 &= \bar{L} \cdot \bar{D}_1 + K\sqrt{\bar{L}}\,\sqrt{\bar{D}_1\,(\bar{D}_1+1)} \\ &= 4 \cdot 100 + 1.5\sqrt{4}\,\sqrt{100\,(101)} \\ &\approx 400 + 300 = 700 \end{aligned}$$

$$ROP_2 = \overline{L}\,\overline{D}_2 + K\sqrt{\overline{L}}\,\sqrt{\overline{D}_2(\overline{D}_2+1)}$$
$$\approx 4 \cdot 400 + 1.5\ (2)\ 400$$
$$\approx 1600 + 1200 = 2800$$

Note that *in this particular case*, the inventory commitment at the reorder point is proportional to the demand. For $\overline{D}$ greater than 10 units per day, we may, with very small error, approximate the reorder level as follows:

$$ROP = \overline{L}\,\overline{D}\left[1 + \frac{K}{\sqrt{\overline{L}}}\right]$$

In summary, when the inventory commitment, that is, the amount on hand or on order of any item, drops below the reorder point, *ROP*, it is time to request an order from the next higher stage of stocks.

DECIDING ON HOW MUCH TO ORDER

Now that we have developed a rule for *when to order*, how shall we decide on *how much to order?* There are generally two costs involved. These are: (1) the cost of ordering, and (2) the cost of carrying inventory. (In the case of ordering from production, there is also the setup cost, which affects the amount to order in much the same manner as the ordering cost.) We would like our reorder quantity to be such that the sum of inventory carrying cost and the costs of placing orders is minimized. That is, if we order small amounts frequently we will have low inventory and low inventory costs but high costs of placing the frequent orders. Conversely, if we place large orders only occasionally, we will have large inventories and high inventory costs, although ordering costs will be low. Somewhere between these extremes there is a reorder quantity where the sum of the ordering costs and the inventory carrying cost is a minimum. This quantity is called the Economic Order Quantity and is abbreviated *EOQ*.

We may illustrate the way in which the *EOQ* is obtained in the following example.

Let $250\,\overline{D}$ be the average yearly demand for a particular item in units, q equal the purchase quantity, C_s be the cost of placing an order, and C_i the cost of holding a unit in inventory for one year. Then $\frac{250\,\overline{D}}{q}$ equals the number of purchases in one year (250 business days) and the purchasing cost is

$$C_s\left(\frac{250\,\overline{D}}{q}\right).$$

Also $q/2$ is the average inventory during the year, and $\frac{C_i\,q}{2}$ is the inventory carrying cost. Then the total expected cost (*TEC*) is

$$TEC = C_s\left(\frac{250\,\overline{D}}{q}\right) + \frac{C_i\,q}{2}$$

The methods of the calculus show us that the minimum total expected cost is achieved when $q = \sqrt{500\,\overline{D}\,\frac{C_s}{C_i}}$.

If we say $\overline{D} = 100$, $C_i = \$1$ per unit per year, $C_s = \$20$, then $q = 1{,}000$, that is,

$$q = \sqrt{\frac{500 \times 100 \times 20}{1}} = 1{,}000.$$

In the case above where we considered the reorder point for

$$\overline{D} = 100,\ K = 1.5,\ L = 4,$$

and determined the *ROP* as 700 units, every time the inventory commitment dropped to 700 units, we would place a reorder for 1,000 units against the next higher stage.

Consider the following example, summarized in Figure II. Assume that the average demand for a given item is 100 units per day at the local warehouse shown, that the demand against the branded stock is 1,000 units per day (remember that the branded stock supports several local warehouses), and the demand for bulk stock is also 1,000 units per day.

Setup plus ordering costs are \$200 at the bulk stage and \$20 at the stages below bulk. We assume that the other

costs used already apply and proceed to calculate the reorder points and economic order quantities for each stage for $K = 1.5$ and the lead-times shown. The results are as shown in Figure II, and the effect of a customer order for 150 units is illustrated.

SAFETY STOCK, CUSTOMER SERVICE AND MANAGEMENT CONTROL

The customers who order from local warehouses generally require immediate service. They feel that the supplier should ship immediately from stock. This is possible only if there is stock on hand, and this is very closely tied in with the control variable, K. K is management's control over the investment in inventory. When K is high, say $K = 3$, the inventory is high, the costs are high, and the service is perhaps much better than anyone ordinarily can afford to give. When K is low, say $K = 0$, the inventory is low, the costs of carrying inventory are low, service is much of the time on a back-order basis and perhaps not tolerated by customers. Somewhere in between is a value of K which will provide a proper compromise between service and cost of service.

There is a very useful measure of whether management has assigned the proper value of K, and that is the number of customer complaints. Often, if there are *no* customer complaints, the service provided is *too* expensive. If customers are lost due to poor service, obviously the service is not good enough. If there are only occasional complaints, then the service is possibly about right. This is, in fact, how management can seek the best level for maintaining a balanced inventory.

The advantages which this type of inventory control system gives to management are:

1. The inventory is in balance; that is, stocks are set in accordance with lead-time, demand, and various costs to give desired customer service by item across the product line.

2. The level of customer service is established by management by assigning K in accordance with their best judgment. Managements have considerable choice in this, for instance, in providing specified service by item classifications. Thus, they may want to offer better service (say $K = 2.0$) for fast-moving items than for slow-moving items (say $K = 1.5$).

Management is also prepared to maintain its position in the face of directives from above. For example, if top management orders a 10 percent cut in inventory, factory management can reduce K in increments to this objective level and still keep the inventory in balance without necessarily causing a crisis in production.

This is but one example of the use of systematic analysis to develop information systems which will aid managements in making decisions. Another example in a different area will be discussed in the second part of this article.

Recovering Overpayment of City Excise Taxes

By MAX BROFMAN

Erroneous tax payments to the City of New York may be recovered by any one of the following three methods: refund procedures outlined by the local laws and regulations; common law action in the courts for money had and received; and application of the doctrine of recoupment. In elaborating upon these methods, the author emphasizes the element of timeliness of refund action and considers such technical features as the form of application to be made or action to be taken.

IN the face of the increase in the number and rates of taxes that have been imposed in recent years, and in the light of recent decisions of the courts holding certain types of transactions in the area of interstate commerce subject to tax, as a result of which the tax burden has become more and more onerous, it might be refreshing to re-evaluate the measures of relief that are available when an overpayment of tax has been made. Surely, a taxpayer whose tax liabilities keep mounting year in and year out should be aware of the available remedies for a refund or any other method of recovery of taxes that might have been overpaid. Accordingly, the purpose of this article is to point out methods by which tax overpayments of New York City excise taxes may be recovered in the event of erroneous overpayment.

Basically, there are three methods of recovering erroneous tax payments made under the City's excise tax laws. Recovery of such tax payments, however, may involve either an actual payment by the City to the taxpayer, or a credit to the taxpayer by way of offset (recoupment) against existing tax liability without necessarily resulting in an actual refund to the taxpayer.

Erroneous tax payments may be recovered by any one of the following methods:

1. In accordance with the refund procedures outlined by the local laws and regulations thereunder, pursuant to which the particular tax was paid.
2. Common law action in the courts for money had and received.
3. Application of the doctrine of recoupment (offset).

REFUND PROCEDURES

The local laws generally provide that an application for refund of taxes erroneously, illegally or unconstitutionally collected or paid, must be filed with the Comptroller within one

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year from the date of payment thereof. The local laws also provide for a hearing upon such application. In event of a denial of application for refund, the determination of the Comptroller denying the refund may be reviewed in the courts through an Article 78 proceeding. An Article 78 proceeding refers to a proceeding against a body or officer brought in the Supreme Court of the State of New York, authorized by Article 78 of the Civil Practice Act.

Of course, if a refund is granted, no court proceedings are necessary. In this connection, no special form of application for refund is required. It must be in writing specifying the amount and type of tax overpaid, the date of payment, and such other information as the Comptroller may require. A cancelled check or other evidence of payment of the tax must also be submitted.

The claim must be signed by the applicant. The important thing to remember is to file the claim within one year from the date of payment of the tax sought to be refunded.

There are other situations where a refund may be made without direct application therefor by the taxpayer. Where the Comptroller finds that the tax was paid erroneously, illegally or unconstitutionally, he may order the refund on his own initiative within one year from the time of payment of the tax. This is currently done in the case of apparent errors appearing on the face of a return. Of course, in such cases as in most other cases where a refund is made, the refund is made subject to further audit by the Comptroller. In some instances, an audit may be directed in the first instance to determine whether a refund is due.

In lieu of a refund, a credit may be authorized to be applied against any taxes due from the applicant on any subsequent returns to be filed by him.

Generally, no refund may be granted under the local law unless the procedure outlined therein for the filing of a claim for rèfund is complied with. This is so by virtue of the exclusive remedy provisions which are found in all the local laws imposing the City's excise taxes. For example, the exclusive remedy provision of the Sales Tax Law reads substantially as follows:

> Remedies Exclusive—The remedies provided by sections N41-7.0 and N41-8.0 of this title shall be exclusive remedies available to any person for the review of tax liability imposed by this title; and no determination or proposed determination of tax or determination on any application for refund shall be enjoined or reviewed by an action for declaratory judgment, an action for money had and received or by any action or proceeding other than a proceeding in the nature of a certiorari proceeding under article seventy-eight of the civil practice act; provided, however, that a taxpayer may proceed by declaratory judgment if he institutes suit within thirty days after a deficiency assessment is made and pays the amount of the deficiency assessment to the treasurer prior to the institution of such suit and posts a bond for costs as provided in section N41-7.0 of this title.

But, assuming a taxpayer has failed to comply with the provisions of the laws by failing to apply for a refund within one year from the date of payment of the tax, does it necessarily mean that he is without remedy in any case for the recovery of an erroneous tax payment? Not necessarily, as will soon be demonstrated.

COMMON LAW ACTION FOR MONEY HAD AND RECEIVED

Despite the exclusive remedy provisions of the local laws, a taxpayer has the right to bring a common law action for money had and received under certain circumstances. Such an action may be brought where the claim is based upon the unconstitutionality of the statute or the inapplicability of the tax to the taxpayer.

(*Title Guaranty & Trust Co.* v. *City of New York,* 265 App. Div. 304, affd. 290 N. Y. 910; *All American Bus Lines* v. *City of New York,* 268 App. Div. 508, affd. 296 N. Y. 571. See also *Richfield Oil Corp.* v. *City of Syracuse,* 287 N. Y. 234; *National Steel Corp.* v. *City of New York,* 1 Misc. 2d 1012, affd. 283 App. Div. 867.)

It must also appear that the tax was paid under protest unless it was made under duress. (*Sloan Estates Inc.* v. *City of New York,* 175 Misc. 674, affd. 262 App. Div. 722, affd. 287 N. Y. 818; *Title Guaranty & Trust Co., supra.*) Finally, a common law action for money had and received must be brought within six years from the date of payment of the tax. However, where the payment was made under mistake of fact, the exclusive remedy provisions requiring the filing of an application for refund within one year from the date of payment may be applicable, and in such case an action for money had and received may not lie.

It is quite obvious that payments made under mistake of fact could not and need not be made under protest and that the protest requirement can only be applicable to payments made under mistake of law. It is also obvious that a tax though not paid under protest, but if paid under duress, could properly be recovered in an action for money had and received. The mere threat to exercise legal rights, such as the threat of making an assessment of tax and penalties, does not constitute duress so as to support an action for money had and received. Nor does the mere provision in the local law imposing the tax and calling for penalties and enforcement in the event of failure to pay the tax, constitute cause for duress. (*United States Envelope Company* v. *City of New York,* 3 N. Y. (2d) 418; *Title Guaranty & Trust Co.* v. *City of New York,* 265 App. Div. 304, affd. 290 N. Y. 910.)

As to the necessity for payments to be made under protest, or under duress, as a basis for an action for money had and received, the Court, in *Mercury Machine Importing Corp.* v. *City of New York,* 3 N. Y. (2d) 418, 425, said:

> Voluntary payments cannot be recovered. *Payment under protest is an indication that a tax is not paid voluntarily.* Protest is not necessary to dispel the implication of voluntariness in event of duress, where present liberty of person or immediate possession of needful goods is threatened by nonpayment of the money exacted (*Peyser* v. *Mayor of City of N. Y.,* 70 N. Y. 497; *Adrico Realty Corp.* v. *City of New York,* 250 N. Y. 29). Payment after a tax has become a lien "is not voluntary, for the menace of the lien with penalties added for delay . . . has the effect of rendering it compulsory" (*People ex rel. Wessel, Nickel & Gross* v. *Craig,* 236 N. Y. 100, 104, and cases cited). In the present instance, this tax has not become a lien, and neither liberty of the person nor immediate possession of needful goods was threatened when these payments were made. Plaintiffs were not under any recognized form of duress (*Tripler* v. *Mayor of City of New York,* 125 N. Y. 617, 626-627), consequently lack of protest is not excused on that ground (*Title Guar. & Trust Co.* v. *City of New York,* 265 App. Div. 304, affd. 290 N. Y. 910; *Sloane Estates v. City of New York,* 175 Misc. 674, affd. 262 App. Div. 722, affd. 287 N. Y. 818). (Emphasis supplied.)

Under the New York City Charter, Section 93d, the Comptroller has power to settle and adjust all claims in favor of or against the City in such manner as shall be prescribed by law. Accordingly, the Comptroller may pay or adjust any claim which in a court action the City would be compelled to pay. The Administrative Code (Section 93d-1.0) states that in settling or adjusting claims, the Comptroller, as far as practicable, "shall be governed by the rules of law and prin-

ciples of equity which prevail in courts of justice." Hence, the Comptroller is barred from settling or adjusting claims filed subsequent to the six-year period of limitation prescribed for an action for money had and received. Consequently, a taxpayer who could properly bring such an action (within the limitations hereinbefore described) may, indeed should, file a claim with the Comptroller for the amount of tax for which such an action may be brought. If the claim, in the judgment of the Comptroller, is such that would be recoverable in an action for money had and received, a refund would be granted.

APPLICATION OF THE DOCTRINE OF RECOUPMENT

Where a refund of an erroneous payment of tax is barred by either a failure to comply with the exclusive remedy prescribed in the local law, or by reason of the fact that an action for money had and received will not lie, such overpayment may be recouped against any determination for tax deficiency made against the taxpayer. This has been established in the case of *National Cash Register* v. *Joseph*, 299 N. Y. 200. In that case, the taxpayer filed a claim for refund for sales tax in the sum of approximately $11,000 for the period from April 1, 1936 to September 30, 1940. The claim was not filed within one year from the payment of the tax. The refund claim arose out of taxes paid by the taxpayer on the full purchase price of installment sales made to New York City customers, which sales were subsequently cancelled because of a default in payment thereof by the purchasers. The claim was filed for the tax paid on the unpaid balance of these cancelled sales. Upon audit, a deficiency assessment for sales tax was made for approximately $45,000 for the period from September 1, 1935 to December 31, 1940. The deficiency was based upon various sales upon which taxpayer did not pay taxes, having claimed deductions which were disallowed on audit. No credit was given in the assessment for the amount of erroneous tax payments for which a refund claim had been filed. The refund claim was denied by the Comptroller.

In an Article 78 proceeding to review the Comptroller's determination of tax deficiency and the Comptroller's determination denying the claim for refund, the taxpayer contended it may recoup the amount of its refund claim because the City opened up the question of the taxpayer's tax liability by making a deficiency assessment for a period which embraced the period covered by the claim for refund. The Court of Appeals, in reversing the Appellate Division and finding for the taxpayer, stated as follows:

> The dissenters in that [Appellate Division] court said: "As respondent (comptroller) has opened the question of petitioner's sales tax liability and determined a deficiency for past years, it seems to us that petitioner should be entitled to set off, against any deficiency finally determined, the amount of any overpayment of sales taxes made during the period under review, although petitioner did not file a timely refund claim." (274 App. Div. 920.) We are of that opinion.
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> "Recoupment" means a deduction from a money claim through a process whereby cross demands arising out of the same transaction are allowed to compensate one another and the balance only to be recovered (*Ives* v. *Van Epps*, 22 Wend. 155, 156-157; *Peuser* v. *March*, 218 N. Y. 505). Of course, such a process does not allow one transaction to be offset against another, but only permits a transaction which is made the subject of suit by a plaintiff to be examined in all its aspects, and judgment to be rendered that does justice in view of the one transaction as a whole. (*Rothensies* v. *Electric Storage Battery Co.*, 329 U. S. 296, 299; *Village of Charlotte* v. *Keon*, 207 N. Y. 346; see *Bull* v. *United States*, 295 U. S. 247; cf. *Lewis* v. *Reynolds*, 284 U. S. 281.)

> Here the city reopened the matter of the sales tax liability of the vendor for the period September 1, 1935, to December 31, 1940, and assessed a tax deficiency against it for that period. The vendor, as we think, was thereby given an equitable right to plead against the city a recoupment claim for taxes of the same type which the vendor (as it alleges) had erroneously paid to the comptroller in the same period.

It is to be noted that the recoupment was allowed since the same type of tax was involved both in the transactions against which a tax deficiency was determined and in those upon which taxes were erroneously paid by the taxpayer.

As a result of that decision, an offset by way of recoupment of the *same type* of tax as has been overpaid will be allowed against the deficiency of the same type of tax, within the period of audit. However, in the event application of the offset would result in a net credit to the taxpayer, no refund thereof will be made to the taxpayer unless a timely application for refund had been made to the Comptroller. Again, it must be repeated that the offset or credit is only allowable by way of recoupment against a tax deficiency, and not as a refund. In order for a tax to be refundable, an application for refund must be made within the time prescribed by the local laws, viz., one year.

While the doctrine of recoupment as applied by the Comptroller relates to offsetting an overpayment of tax against a deficiency of tax of the same type, an exception has been made in the case of utility and business tax. For example, an overpayment of sales tax will be offset against a sales tax deficiency, but will not be allowed against a utility or business tax deficiency since the sales tax, which is a transaction tax, is different in type from the utility or business tax. On the other hand, where a payment has been made of a business tax when, in fact and in law, a utility tax should have been paid, or vice versa, the Comptroller has allowed an offset by way of recoupment of an overpayment of the business tax against a utility tax deficiency, and vice versa. This is on the theory that the business tax and the utility tax are deemed to be of the same type of tax, to wit, a privilege tax. In no event, however, will a refund be made of any overpayment of tax unless a timely application for refund therefor had been made to the Comptroller.

One further word in connection with the doctrine of recoupment. It is not applicable, even where the same type of tax is involved, to erroneous *tax collections* which are sought to be offset against the taxpayer's own tax liability. For example, a contractor who is engaged for a lump sum in the repair, alteration, or construction of real property, and who erroneously collects sales tax on the total charge or any portion thereof made by him to his customer, may not claim the right to offset such erroneous sales tax collections against a tax deficiency determination against him as the purchaser of all materials used or consumed by him and for which he is liable for the sales tax. In such case, while the same type of tax is involved, nevertheless, the customers who erroneously paid the tax might have the right to make application to the Comptroller for refund. To permit offset to the contractor in such case would be giving him credit against his own tax liability for taxes not paid by him, but erroneously collected by him from others. (Cf. *Matter of Kesbec* v. *McGoldrick,* 278 N. Y. 293.)

It should be observed, however, that an offset by way of recoupment for overpaid taxes against a tax deficiency is only available upon an audit of the taxpayer's books and records resulting in a determination of tax de-

ficiency. Thus, where no other remedy is available for the recovery of an overpayment of tax, the only recourse is to await such time as the Comptroller may audit the taxpayer's books and records for the period that embraces the period for or during which the overpayment of tax was made. Then, of course, on audit, a tax deficiency must be determined in order that the doctrine of recoupment might be applicable.

Basic Ethical Principles

It seems to me that there are three basic principles of conduct for the accountant in practice. The first is that the member must be honest with himself and with others, a man of integrity, character and common sense. The second, of equal importance, is that he should do unto others as he would that they should do to him. The third is that he should do all that he can to maintain the esteem and respect in which his profession is held by the public. . . .

The chartered accountant must not certify or sign something which he does not believe to be true. He must not allow himself to believe something to be true unless and until he has obtained adequate and proper evidence, weighed it duly in the balance and found on adequate and proper grounds that it justifies his finding. In deciding whether any particular thing is true or false he must try to put himself in the position of an intelligent reader who is without inside information and see whether such a person would be likely to be misled. Clever combinations of words which are literally correct but convey a misleading significance to an intelligent reader should be avoided.

Sir Thomas Robson, "Ethics for the Accountant in Practice," The Accountant [England], April 1960

Depletion In The Oil And Gas Industry

By HARRY I. COBERN, CPA

The various aspects of the depletion problem are covered in this article. The author first defines the various terms, such as Book Cost Depletion, Tax Cost Depletion, Percentage Depletion, Allowable Depletion, Reduction in Basis Depletion and Excess Depletion. By means of a comprehensive illustration, he then proceeds to explain each of the applicable calculations.

ANY discussion of depletion in the oil and gas industry must, by its nature, lead to many other problems peculiar to the industry. This article, however, will deal specifically with the depletion problems affecting both the operator of, and the investor in, oil and gas properties. For the operator, the article will be concerned with both the financial and federal income tax reporting problems. For the investor, only the federal income tax reporting problems will be discussed. As an introductory consideration, it may be noted that an investment may be in the form of a lease interest, a landowner's royalty, an oil payment, or other economic interest. The investor generally relies on the operator to furnish him with the information from which to calculate depletion. This information comes to the investor either in the form of a copy of a partnership return or as an accounting by the operator of the funds of the operation.

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DEFINING THE TERMS

FINANCIAL ACCOUNTING

Property subject to depletion. Otherwise known as the "depletable asset," this item represents the amount invested in an economic interest in an oil or gas property. Excluded are amounts expended for items subject to depreciation. For financial reporting purposes, the asset includes development expenses and those completion costs which are not in the nature of depreciable property. Intangible drilling costs are generally considered part of the asset. For tax purposes, however, intangible drilling costs usually are deducted as incurred and are therefore not considered part of the asset.

Book cost depletion. This term describes that portion of the depletable asset which has been exhausted each year. The amount is determined by first dividing the book value of such property at the end of the year (before provision for current year's depletion)

by the estimated remaining barrels of oil or m.c.f. (1,000 cubic feet) of gas to be recovered as of the end of the year (before current year's production). This gives the depletion unit or rate of depletion for each barrel of oil or m.c.f. of gas produced. Book cost depletion is calculated by multiplying the number of units produced by the depletion per unit.

FEDERAL INCOME TAX REPORTING

Property subject to depletion. For tax purposes [1] this generally differs from the asset as defined for purposes of financial accounting. The basic difference is accounted for by the intangible drilling costs which the operator has elected to deduct currently. Property is defined in the Internal Revenue Code of 1954 [2] as each separate interest owned by the taxpayer in each mineral deposit in each separate tract or parcel of land. The Code requires that depletion be computed by property,[3] except that certain interests may be aggregated.[4] The basis of this property is the same as that used for the determination of gains under Section 1011.[5]

Gross income from property. This represents the proceeds (net of royalties and severance taxes) from the sale of oil and gas extracted from the property, and is the basis used for computing the depletion deduction under the 27½ percent test. Gross income has been further defined as the amount for which the taxpayer sells oil and gas in the immediate vicinity of the well.[6] It should be noted that miner-producers of tiles,[7] bricks,[8] cement,[9] and chemical-grade limestone [10] may consider the proceeds of sales of these end products as gross income for depletion purposes. However, the regulations [11] and the courts [12] state that where gas or oil is not sold on the property, but is transported away from the property and/or converted into a refined product prior to sale, the gross income from the property is the value of the oil or gas at the well before such transportation or refining.

Taxable income from property. Previously referred to in the 1939 Code as "net income from property," it is computed by subtracting from the gross income not only all costs and expenses directly attributable to each property but also an allocated portion of the company's overhead; and it is the basis used for computing the depletion deduction under the 50 percent limitation. Direct costs attributable to each property include, amongst other things, those development costs and intangible drilling costs which the operator has elected to deduct currently, and depreciation on the equipment being utilized at each producing site. Overhead, for this purpose, includes interest on moneys employed

[1] All section references refer to the Internal Revenue Code of 1954.

[2] Sec. 614 (a).

[3] Sec. 612.

[4] Sec. 614 (c).

[5] Sec. 612.

[6] Regs. Sec. 1.613-3 (a).

[7] *Cherokee Brick & Tile Co.* v. *U. S.*, 122 F. Supp. 59 (DC Ga. 1954), 46 AFTR 223 aff'd. 218 F 2d 424 (CA-5, 1955), 46 AFTR 1474.

[8] *Merry Bros. Brick & Tile Co.* v. *U. S.*, (DC Ga., 1956) 145 F. Supp. 186, 50 AFTR 414, aff'd. 242 F. 2nd 708 (CA-5, 1957), 50 AFTR 2062, *cert. den.*, October 14, 1957.

[9] *Dragon Cement Co., Inc.* v. *U. S.*, 244 F. 2d 513 (CA-5, 1957), 51 AFTR 429, vacating and remanding 144 F. Supp. 188 (DC Me. 1956), 50 AFTR 364, *cert. den.*, October 14, 1957.

[10] *Commissioner* v. *Iowa Limestone Company*, 28 TC 881, aff'd. 269 F. 2d 398 (CA-8, 1959), 4 AFTR 2d 5091.

[11] See note 6 *supra*.

[12] *Greensboro Gas Co.* v. *Commissioner*, 79 F. 2d 701, 16 AFTR 854 (CCA 3, 1935).

directly or indirectly in acquiring and/or operating the property, and all other expenses with the exception of those charitable contributions which are not attributable to the mineral property.[13]

An owner of a royalty or an oil payment does not contribute toward the direct costs and expenses of operating the property; therefore, these items will not enter into his computation of "taxable income from property."

Percentage depletion. This is 27½ percent of gross income from property limited to 50 percent of taxable income from property. Percentage depletion is computed separately for each property.[14]

Tax cost depletion. This is calculated in the same manner as "book cost depletion," previously discussed, but with three major differences: (1) the tax basis of the depletable asset is used rather than the basis for financial purposes; (2) the basis is reduced by the "allowable depletion" (discussed below), which may or may not be the same as "tax cost depletion"; and (3) tax cost depletion is computed by reference to minerals *sold,* whereas book cost depletion is based upon *production.*

Allowable depletion. This item is the greater amount of either "percentage depletion" or "tax cost depletion," computed separately for each year and for each property.

One of the changes brought about by the 1954 Internal Revenue Code deals with the effect of percentage depletion upon the net operating loss carryforwards and carrybacks. Under the 1939 Code, for purposes of computing a net operating loss deduction, "allowable depletion" was ignored and only "tax cost depletion" was permissible in computing the profit or loss for any year entering into the calculation of the net operating loss deduction. Under the 1954 Code the full benefits of "allowable depletion," regardless of how computed, are available in computing net operating loss deductions. Section 172 (g) presents the special provisions dealing with the carryback of losses from a year covered by the 1954 Code to a year or years covered by the 1939 Code.

Reduction in basis depletion. As noted previously, the tax basis of the depletable asset is reduced by the allowable depletion. Since the tax basis of an asset may not be reduced below zero (nor does Section 1011 of the Code contemplate a negative basis), the cumulative allowable depletion which may reduce the basis of the asset is limited to the tax basis of that asset. All allowable depletion up to and including the total tax basis of the depletable asset is known as *reduction in basis depletion.*

Excess depletion. As a taxpayer may continue to claim percentage depletion even after he has recovered the tax basis of the asset, the allowable depletion in excess of the basis of an asset is known as *excess depletion.*

Reduction in basis depletion is an important factor in determining earnings, and also accumulated earnings available for dividends. This amount should be substituted for *allowable depletion* in the determination of earnings for dividend purposes, which in turn affects the taxability of dividends paid by certain corporations which own or operate interests in oil and gas properties.

EXPLANATION BY ILLUSTRATION

ASSUMPTIONS

For purposes of illustration, the writer has created a hypothetical entity,

[13] Revenue Ruling 60-74.

[14] Sec. 613.

namely the XYZ Co., which operates the John Doe lease. XYZ Co. owns a 50 percent working interest in this lease. John Doe, the landowner, receives a one-eighth royalty in any gas or oil produced on his acreage. This illustration will deal with the depletion calculations relating to XYZ Co.'s working interest in this lease. It should be noted that these calculations would be the same if the XYZ Co. owned the 50 percent working interest and was not the operator.

Let us assume that in 1953 the XYZ Co. paid $50,000 for its 50 percent interest in this leasehold, and spent $25,000 (deducted on its 1953 tax return) for its share of the intangible drilling costs (capitalized on its books), making a total investment of $75,000. XYZ Co. also expended $15,000 for its share of the pipe and other depreciable equipment necessary to complete the wells. The lease became productive on January 1, 1954. During 1954 the engineers estimated that there were 200,000 barrels of oil in place on the John Doe lease, so that XYZ Co.'s share will be 100,000 barrels. We will assume further that the John Doe lease is the only source of income of the XYZ Co. during the years 1954 through 1958.

Exhibit I calculates percentage depletion based on the above assumptions as to XYZ Co.'s share of the production, revenues, costs and expenses involved in the operations of the John Doe lease and the administration of the company for the years 1954 through 1958. In this over-simplified example, it is assumed that the oil runs are sold in the same year as they are produced. The gross revenues represent XYZ Co.'s share of the proceeds of the sale of the oil drawn from this lease and consist of 50 percent of the revenues after providing for the payment of the landowner's royalty. For simplification, we will assume that the average proceeds to the XYZ Co. is $2 per barrel of oil.

In the usual case, where a company operates more than one lease, overhead and administrative expenses are allocated to each lease on the basis of either direct costs or revenues. In this illustration, XYZ Co. is operating only this one lease; therefore, all overhead and administrative expenses are chargeable against the income derived from this one operation. We will assume further that the XYZ Co. paid no interest and made no charitable contributions.

Exhibit II is a calculation of tax cost depletion for each of five years.

Exhibit III is a calculation of depletion for financial accounting and a summary record of the effect of the various depletion calculations upon the tax basis of the leasehold interests.

Exhibit IV illustrates the various factors entering into the calculation of the taxable income, the earnings and accumulated earnings available for dividends, and also the taxability of these dividends.

In the ensuing discussion, references to specific figures in these exhibits are parenthetically noted by Roman and Arabic numbers which refer, respectively, to the particular exhibit and line.

THE CALCULATIONS

The book cost depletion (III-1) is computed by multiplying the number of barrels of oil produced for the years 1954, 1955 and 1956 by $.75 ($75,000 investment divided by 100,000 barrels of oil). However, 70,000 barrels of oil had been produced and sold by the end of 1956, and the book value of the leasehold interest then stood at $22,500 ($75,000 original investment, less $52,500 of book cost depletion). As

40,000 barrels of oil were produced in 1957, the unit rate became $.5625 per barrel ($22,500 divided by 40,000 barrels). Book cost depletion for that year is $22,500 (III-1), the remaining book value of the leasehold interest.

It should be noted that major oil companies review and revise their estimates of recoverable reserves periodically. Based on the revised estimates, a corresponding change is made in the per unit rate of depletion. In this example it is assumed that there was no revision in the estimates of recoverable reserves.

For the year 1954, percentage depletion was limited to 50 percent of net income, as this was less than 27½ percent of gross income as shown on Exhibit I. Tax cost depletion for 1954, as shown on Exhibit II, amounted to $7,500 (15,000 barrels @ $.50), and thus became the allowable depletion claimed by XYZ Co. on its tax return (IV-2). The tax return showed a taxable income of $4,500 (IV-4) and earnings, and accumulated earnings

EXHIBIT I
Calculation of Percentage Depletion
1954-1958

	1954	1955	1956	1957	1958
	$	$	$	$	$
1. Gross revenue from lease (XYZ Co. share)	30,000	80,000	30,000	80,000	40,000
2. Direct cost (lease operating expenses, etc.)	10,200	15,200	22,200	26,400	12,000
3. Depreciation on lease equipment	1,800	4,800	1,800	3,600	—
4. Overhead and administrative expenses allocated to lease	6,000	10,000	12,000	15,000	6,000
5. Net income (loss) from operation of lease (Line 1 minus the sum of Lines 2, 3 and 4)	12,000	50,000	(6,000)	35,000	22,000
6. 50% of net income from operation of lease (Line 5)	6,000	25,000	—	17,500	11,000
7. 27½% of gross revenue from lease, Line 1....	8,250	22,000	8,250	22,000	11,000
8. Percentage depletion (Lower of Line 6 or Line 7; enter on Exhibit III, Line 2)	6,000	22,000	—	17,500	11,000

EXHIBIT II
Calculation of Tax Cost Depletion
1954-1958

	1954	1955	1956	1957	1958
1. Remaining tax cost basis—beginning of year	$ 50,000	$42,500	$20,500	$13,667	$ —
2. Estimated remaining barrels—beginning of year	100,000	85,000	45,000	30,000	—
3. Tax cost per barrel (Line 1 ÷ Line 2)	$ .50	$ .50	$ .4555	$ .4555	$ —
4. Runs (sales) for year in barrels	15,000	40,000	15,000	40,000	20,000
5. Tax cost depletion (Line 3 X Line 4; limited to remaining balance as shown on Line 1; enter on Exhibit III, Line 3)	$ 7,500	$20,000	$ 6,833	$13,667	$ —

EXHIBIT III

Calculation of Depletion for Financial Accounting, and Allowable Depletion and Excess Depletion for Tax Purposes 1954-1958

	1954	1955	1956	1957	1958
FINANCIAL ACCOUNTING					
Runs in barrels (produced and sold) each year	15,000	40,000	15,000	40,000	20,000
	$	$	$	$	$
1. Book cost depletion (limited to $75,000)......	11,250	30,000	11,250	22,500	—
FEDERAL TAX REPORTING					
2. Percentage depletion (Enter from Exhibit I, Line 8)	6,000	22,000	—	17,500	11,000
3. Tax cost depletion (Enter from Exhibit II, Line 5)	7,500	20,000	6,833	13,667	—
4. Allowable depletion (Higher of Line 2 or 3)	7,500	22,000	6,833	17,500	11,000
5. Remaining tax cost basis (Beginning of year)	50,000	42,500	20,500	13,667	—
6. Reduction in basis depletion (Line 4, limited to Line 5; limited to $50,000)	7,500	22,000	6,833	13,667	—
7. Excess depletion (Line 4 minus Line 6)	—	—	—	3,833	11,000

EXHIBIT IV

Calculation of Taxable Income, Earnings, Accumulated Earnings, Dividends and Taxability of Dividends 1954-1958

	1954	1955	1956	1957	1958
	$	$	$	$	$
1. Taxable income (loss) before depletion or taxes (Exhibit I, Line 5)	12,000	50,000	(6,000)	35,000	22,000
2. Allowable depletion (Exhibit III, Line 4)	7,500	22,000	6,833	17,500	11,000
3. Reduction in basis depletion (Exhibit III, Line 6)	7,500	22,000	6,833	13,667	—
4. Net taxable income (loss) for purposes of computing federal income taxes and net operating loss deduction (Line 1 minus Line 2)	4,500	28,000	(12,833)	17,500	11,000
5. Federal income tax (assumed to be 50% of net taxable income)	2,250	14,000	(6,417)	8,750	5,500
6. Current earnings (before dividends) for purposes of determining taxability of dividends (Line 1 minus Lines 3 and 5)	2,250	14,000	(6,417)	12,583	15,500
7. Accumulated earnings before current dividends [accumulated earnings at end of previous year (Line 9 of previous year), plus current year's earnings (Line 6)]	2,250	14,250	(7,167)	2,416	12,916
8. Current dividend	2,000	15,000	3,000	5,000	10,000
9. Accumulated earnings after dividends (Line 7, minus Line 8)	250	(750)	(10,167)	(2,584)	2,916
10. Taxable dividend (Line 8 limited to Line 6 or 7, whichever is greater)	2,000	14,250	—	5,000	10,000
11. "Nontaxable dividend"—return of capital (Line 8, minus Line 10)	—	750	3,000	—	—

available for dividends of $2,250 (IV-6, 7). As the dividends paid were $2,000 (IV-8), they were fully taxable. With the allowable depletion being $7,500, the tax basis of the leasehold interest was reduced from $50,000 to $42,500.

Percentage depletion for the year 1955 was based on 27½ percent of gross income (I-7), which was less than 50 percent of net income (I-6). Percentage depletion of $22,000 (III-2) exceeded tax cost depletion, (III-3) and became the amount of the deduction claimed by the company. The taxable income for 1955 was $28,000 (IV-4); the current earnings were $14,000 (IV-6); the accumulated earnings before current dividends were $14,250 (IV-7). The dividends paid of $15,000 (IV-8) exceeded the accumulated earnings by $750; therefore, only $14,250 (IV-10) of the dividends paid constituted taxable income to the stockholders, and the balance of $750 (IV-11) constituted a return of capital or a so-called "non-taxable dividend," until basis is recovered, and then treated as capital gain. Although tax cost depletion for 1955 amounted to only $20,000 (II-5), the tax basis of the asset was reduced by the full amount of allowable depletion of $22,000 (III-4).

The lease operations and consequently the company's operations for the year 1956 resulted in a loss of $6,000 (IV-1); therefore, there can be no percentage depletion. The allowable depletion and also the reduction in basis depletion was the tax cost depletion of $6,833 (15,000 barrels @ $.4555) (III-3,4,6). As at December 31, 1956 the tax basis of the leasehold interest stood at $13,667.

The tax return of the company for the year 1956 showed an operating loss of $12,833 (IV-4) which, under the present law, may be carried back to both 1954 and 1955 to recover part of the taxes paid for those years (IV-5). As there were neither current earnings nor accumulated earnings available for dividends, the dividend paid during the year will be treated as a return of capital (IV-11). It might be noted that the right of a corporation to pay dividends depends on the laws of the state of its incorporation and not on the earnings or accumulated earnings as computed for tax purposes.

In 1957, percentage depletion based on 50 percent of taxable income was $17,500 (III-2). Tax cost depletion was limited to the remaining tax basis of the asset, or $13,667 (III-5). Of the $17,500 allowable depletion (IV-2), $13,667 (III-6) was used to reduce the tax basis of the asset to zero. The balance of the allowable depletion $3,833 (III-7), was considered as excess depletion. Current earnings of $12,583 (IV-6) were computed by reducing the taxable income (before depletion and taxes) of $35,000 (IV-1) by the reduction in basis depletion of $13,667 (IV-3) and the federal income taxes of $8,750 (IV-5). Despite the fact that the 1957 dividend (IV-8) exceeded the accumulated earnings (IV-7), the full amount of the dividend constituted taxable income to the stockholders (IV-10), because the current earnings (IV-6) exceeded the dividend.

Unless there will be additional amounts capitalized as investments in this leasehold interest, there can be no tax cost depletion in 1958 or any subsequent year. Also, as there is no longer any tax basis to the asset, there can be no further reduction in basis depletion. The percentage depletion will be the allowable depletion and in each year will constitute excess depletion. In 1958, both current earnings and accumulated earnings exceeded the dividend; therefore, the dividend was fully taxable (IV-10).

Integrated Data Processing and the Smaller Company

By John J. Fox, CPA

The research involved in developing high-priced electronic computer systems has had tremendous impact on the more conventional integrated data processing techniques for smaller companies. These new developments affecting such companies are discussed under six broad classifications: streamlining office methods; automatic paper tape or card punching; conventional office machines; automatic data processing; reporting to management; and applications of science to decision making.

During recent years, business has been confronted with constantly increasing work loads. The proportion of clerical workers to non-clerical workers has steadily risen. This is a matter of great concern and becomes a matter of greater significance when declining business volume is reducing profit. Control and reduction of clerical cost and paperwork become especially significant under these circumstances.

The most significant of recent developments in the war on paperwork is the development of electronic computer systems for business applications. Many of the larger companies have installed expensive computer systems and claimed substantial resultant savings. The owners of small and medium-sized businesses have read of these developments with great enthusiasm, only to learn that the price of the equipment is out of their reach.

All of this publicity devoted to the high-priced electronic computer systems has obscured the tremendous impact on small and medium-sized businesses of improvements in conventional office machines and systems techniques resulting directly or indirectly from the research involved in electronic computer installations. Even the smallest of businesses can share in the benefits resulting from the study and research required for developing and installing electronic computer systems in the large business organization.

Perhaps the greatest benefits of recent research and developments in system techniques are in the field of integrated or automatic data processing which has also been widely publicized in connection with electronic computer installations. Integrated or automatic data processing is the gathering and original recording of

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data in a form that permits the processing of that data for several different purposes without any intermediate manual transcriptions. Not only is integrated data processing particularly important in an electronic computer installation where millions of dollars worth of equipment capable of producing thousands of answers a second must wait on the relatively slow processes of converting data to a form acceptable to the equipment, but it is also important in the mechanical and manual installations of any office. Integrated data processing applies to all forms of data processing—electronic, mechanical and manual.

Executives responsible for controlling clerical costs and improving profits should be aware of improvements resulting from recent research in:

1. Streamlining office methods.
2. Automatic paper tape or card punching.
3. Conventional office machines.
4. Automatic data processing with conventional office devices.
5. Reporting to management.
6. Applying science to solution of business problems.

STREAMLINING OFFICE METHODS

Experiences with preliminary studies for electronic computer installation in many companies have disclosed the need for substantial system improvements before an electronic computer could be effectively employed. Most companies making such studies have found it necessary to improve clerical processes before the electronic equipment could be economically employed. Those most concerned with the economic justification of computer installations have projected startling savings in clerical costs, but in many instances a substantial portion of the savings has been attributed to improved procedures and methods rather than to the equipment itself. In one instance, a very substantial portion of the projected clerical savings was achieved even before the computer was delivered. These savings could have been achieved independently of any computer installation.

Such experiences with electronics simply point up in a dramatic fashion a conclusion which has long been accepted by experienced procedure analysts, i.e., mechanical equipment is only a part of a system and no installation of equipment should be undertaken wthout a thorough consideration of the related factors of work flow, work load, input media and output media. The desired results of more rapid data processing and clerical work reduction are often more closely related to methods and procedures revision than to the equipment.

The lessons to be learned from these experiences are:

1. You don't need an electronic computer installation to realize savings from methods improvements.

2. Conversely, any installation which superimposes new devices on existing methods and procedures, while it may result in some cost savings, usually does not realize the maximum cost savings because it tends to perpetuate the inefficiencies in the previously existing methods and procedures.

AUTOMATIC PAPER TAPE OR CARD PUNCHING

Punched card accounting has benefited greatly from recent research. The office equipment industry has developed and introduced a host of new devices which mechanically provide a link between conventional office machines and punched card equipment. These devices automatically create punched cards or punched paper tapes at the same time as the original data are being recorded on source docu-

ments in the conventional office machines. Obviously, these devices practically eliminate the clerical time previously required to key punch the data into the punched cards from the source documents and to verify the accuracy of the key punch.

These devices are now on the market in quantities and are finding acceptance for many diverse operations in relatively small office operations. Some of the common office machines which can be linked to punched paper tape or punched cards with such accessory mechanisms include: typewriters, bookkeeping machines, cash registers, adding machines, and calculators.

Let us consider some representative examples of conventional office machines equipped for producing punched paper tapes or punched cards.

The Flexowriter is a typewriter which can be activated by a prepunched tape or an edge punched card and it can produce a tape as a byproduct of a normal typing operation. This machine might be used by a typist preparing a customer order in this manner:

1. Insert a prepunched customer master tape or edge punched card to cause the typewriter to record the standard customer information on the form.

2. Manually type the variable information such as date, order number, description, quantity, etc., on the form.

So far, a large part of the typing (40 to 60 percent) has been done automatically at a high rate of speed (100 words per minute). Only the manually typed data need be checked for error. At the same time that the order is being prepared, another punched paper tape is being created from which punched cards may be produced or another Flexowriter actuated to rewrite the data.

In multiple location businesses, this tape could be either mailed or telegraphically transmitted and reproduced over a public or private communications network to a central control location. The tape, when received, could be processed through a "tape to card" converter which would provide punched cards for processing on punched card equipment into analysis reports. This procedure would accomplish the dual purpose of eliminating the manual duplication of basic data, with its inherent risk of transcription errors and minimizing the cost of key punching and verifying operations. The tape might even be put to further use for automatically typing other documents such as factory orders, shippers and invoices.

A variation of this hypothetical application might be producing two tapes at the originating point, one containing all the data shown on the order, the other, which would be punched on an auxiliary perforator, containing only selected data for statistical purposes.

In this hypothetical application, the data are "captured" at the point of origin as a by-product of a normal typing operation; typing time is saved; key punch and verify time is minimized; current reports rather than historical records are produced; and customer service is improved.

More than twenty years ago Remington Rand introduced a machine designed to automatically produce punched cards as a by-product of a billing application. This principle has been developed and widely expanded in recent years so that smaller offices which cannot economically justify tabulating equipment find these devices highly practical to produce data on punched cards which can then be submitted, as desired, to a tabulating serv-

ice bureau for preparation of various analytical reports.

Leading posting machine companies have similarly developed accessory equipment which will produce punched paper tape or punched cards as a by-product of posting operations on conventional accounting machines.

The National Cash Register Company has developed and adapted to its bookkeeping and adding machines, a device which directly punches selected data on I.B.M. cards automatically while normal machine functions are being carried on.

The National Cash Register Company has introduced a special design banking machine for savings accounts which records old balance pick ups, deposits or withdrawals, interest credits or payments, new balance and account number. Other developments include cash registers with five or eight channel tapes, multiple totals, and media readers. The media reader in combination with the NCR 6000 class cash register can automatically complete a sales distribution, sales audit, and inventory control distributions. The media reader, originally designed for department store use to automatically read merchandise tickets, is now being extended to industrial applications for recording material releases and other inventory control problems.

In the field of retailing, marking machines which produce punched card garment tags are now available. As a result, the information coded on the tags can now be processed directly through punched card equipment to provide management with sales data for control purposes, on an up-to-the-minute basis and at a lower cost.

The potential of this equipment for expediting data processing can best be illustrated by reviewing a few actual installations.

A retail store was confronted with a problem concerning the audit of sales slips. Basically, this was an adding machine operation; however, a substantial amount of rehandling and reclassifying of the original data was required to provide other data for sales analyses, inventory control, and buying functions. After consideration of the reporting requirements, a system was developed which incorporated a key driven adding machine with a punched tape attachment. As the sales slips were added, supplemental identifying information was also introduced into the machine which then produced not only the sales slip totals, but also simultaneously and automatically punched all the information on a paper tape. By use of a "tape to card" converter, the information was then automatically placed on punched cards for processing in any desired form. Through this technique, reports for sales analysis, inventory control, buyer information, sales tax, federal tax and sales volume were all mechanically produced from the single manual recording of the source data.

Another installation involves a multiple location manufacturing firm which required daily current operating data relating to production by department and job number for each plant. A system was developed whereby each plant submits totals of its daily production tickets prepared on a conventional office machine to which is attached an automatic paper tape punch device. As in the retailing example, identifying information as to the job and department number is entered on the machine along with the basic data. The punched codes on the paper tapes, which are automatically produced at the time of recording the original documents, are transmitted over a leased communication line and reproduced at the company's central office each day. Tapes from each location are fed into a tape

reading typewriter to produce the required daily reports, following which the tapes are run through a "tape to card" converter for subsequent tabulating of various analysis reports.

It should be noted that Western Union, Bell Telephone and other firms have specially designed equipment available for reproduction of punched (and magnetic) tape over communication lines between remote locations. Card to card transceivers, connecting locations separated by a few or thousands of miles, are also available. On this equipment, a control switch permits direct voice communication or automatic data transmission, selectively, on the same circuit.

The equipment and system developments noted in the preceding paragraphs afford ample opportunity for any company using punched card equipment to develop integration in its data processing. Of even greater significance to the smaller business, however, is the increasing availability of service bureau facilities for processing the punched tapes and cards produced as a by-product of its clerical functions. Most larger cities and many smaller ones have competent service bureau organizations which can and do process punched tapes and cards into desired reports at reasonable prices. The availability of such facilities can reduce equipment investment costs to such a degree that even the smallest business can consider using these methods.

While the time factor may create problems in using service bureau facilities for "on line" accounting functions, this factor may be of much less significance in the processing of supplemental analysis reports. For example, daily sales tickets can be summarized by adding machine with a tape punching mechanism. The daily adding machine summary can produce control totals for cash and charge sales, departmental totals, and any other information required for entry in the bookkeeping systems. The punched paper tapes produced simultaneously can be processed by a service bureau to produce desired supplemental reports, perhaps on a weekly basis, of sales by item for stock replenishment purposes, commission computations, comparisons with budget and other desired information which may not be required every day.

CONVENTIONAL OFFICE MACHINES

The intensive research which has produced the electronic computers for business and the paper tape and card punching conversion devices is currently resulting in greatly improved office machines in price ranges which medium and small-sized companies can afford. Many of these developments involve the incorporation of electronic circuitry in conventional office machines. Some are new developments of general-purpose office machines while others are specialized machines which can produce great savings in the specific types of operations for which they have been designed.

Significant improvements in the general-purpose posting machines have resulted from the intensive rivalry between the leading companies in the field. In addition, a number of European manufacturers are now marketing improved bookkeeping machines in the United States, some of which are available at relatively low prices and are worthy of consideration for simple applications.

The heavy volume of paperwork required in the banking field has caused equipment manufacturers to devote a substantial portion of their research to the development of equipment designed to specifically fill the requirements of banks. Some of this equipment will also be of great value in non-banking situations where the clerical processes

have similar characteristics to those in banks. The National Cash Register Company has introduced a "Postronic" machine, and the Burroughs Corporation has introduced a "Sensitronic" machine. These machines incorporate certain electronic circuitry in machines designed for ledger posting operations. Both machines feature automatic account number, item counts and account balance from magnetic code strips on the reverse of the ledger card. In a typical operation, the ledger card is inserted into the machine. The account number is manually registered by the operator. If the account number registered by the operator agrees with the account number coded on the ledger card, the machine will immediately and automatically enter the old balance and item count to date. The operator then enters the present day's items and the machine automatically enters the new balance and item count. These machines are equipped with proof devices such as automatic locks if the account numbers do not agree.

The Burroughs "Sensitronic" also features a ledger-form feed device which automatically inserts ledger forms, enabling the machine to take automatic trial balance listings and accumulations. NCR is now marketing a "Fully-Automated Postronic" which features automatic posting of account ledgers by reading input transaction data in the form of prepunched paper tape, and mechanical insertion of ledger forms via an automated form feed device. This equipment could be of value in any situation where high volume posting is required.

Another interesting innovation for processing banking documents is the check encoder and check reader-sorter. IBM, Burroughs, and NCR have developed new machines of this type. The encoder imprints account number and other data in arabic characters on checks and other documents; the sorter-reader is capable of sensing these characters and sorting the documents. Another function of the sorter-reader is to print-list the amounts encoded on the documents. Some models can punch the document data into paper tape and/or feed this information directly to punched card or computer processing equipment. The encoder and sorter-reader are applicable to other businesses, such as department stores for sales audit and accounts receivable applications.

Electronic calculators are being added to electro-mechanical office machines, as illustrated by the National Cash Register "Computronic," and the IBM "632," an Electronic Typing Calculator. The Desk Model Computer, such as the NCR "390" and the Burroughs "E101," both using accounting machines as printing devices, are available for specialized applications in a wide range of industries.

The Royal McBee "Roy-tronic" electronic tabulation typewriter is another office machine incorporating electronic circuitry. This typewriter is equipped with a sensing device which sweeps the surface of the form being typed and automatically stops the carriage movement at any one of several pre-printed or manually mark-sensed lines on the form. Insurance companies and others having substantial volumes of form-typing operations will be able to eliminate a substantial portion of the typing time consumed in manually tab setting typewriters.

All of the described devices are available at prices which are economically feasible in medium sized and small companies. Research activities in the office equipment field are proceeding at a high rate and continued equipment innovations can be anticipated.

AUTOMATIC DATA PROCESSING WITH CONVENTIONAL OFFICE DEVICES

Integrated or automatic transmission of data from one clerical operation to another can be economically achieved in even the smallest of companies through the use of properly designed forms involving the use of carbon papers and/or one of the many reproducing processes. Several different reproducing processes are available alone or in combination with snap-out forms to minimize unnecessary copying of data.

One of the common applications for this type of equipment is in the field of sales order, shipper and invoice preparation. You will readily appreciate that in many companies, these documents, plus bills of lading, packing slips, shipping labels, etc., contain constant repetition of data such as the following: customer's name, address and order number; description of item; quantity ordered; sales terms; and shipping instructions. Many systems provide for manually copying identical data on a number of uncorrelated and different documents at various times during their processing. Each transcription, in addition to being a duplication of effort, presents the possibility and even probability of human error in transcription, making it necessary to introduce additional verification steps.

A common system for reducing unnecessary transcriptions is to type the incoming order when received on a master capable of being reproduced in one of the systems mentioned. At subsequent points in the process, variable data such as quantity shipped, quantity back ordered, selling price and extensions are added to this master without ever manually transcribing the constant data.

In a variation of this system, the original order is written on a snap-out form, one copy of which can be used as a master for subsequent reproduction.

Another simple form of integrated data processing is accounts receivable applications in which a reproduction of the customer invoice becomes the accounts receivable ledger file copy. Firms such as Remington Rand, Diebold, and many others are providing the necessary filing equipment for such systems. There are very real savings from systems applications of this type in some relatively small companies.

The pegboard is another application for automatically transcribing data from one operation to the next in the smaller company. It is quite evident that many adaptations for this equipment have been overlooked in the past as was indicated by the interest shown by the small businessman (employing from 10 to 50 people) at a recent trade association conference. The pegboard is a device for positioning several forms on a board in such a manner that identical data are entered on several related documents simultaneously. This device is most widely used for payroll work where simultaneous entries are recorded on a pay stub, a payroll register and an earnings record card. This eliminates two transcriptions of identical data. The same principle can be applied to accounts receivable, accounts payable and other accounting processes. For the small business that cannot afford more expensive accounting machines, this system is ideal because of the low capital investment required and the great productivity increase when compared with entirely manual methods. Businessmen may well wish to consider the application of this method to certain lower volume operations currently placed on bookkeeping machines, particularly where machine schedules are crowded. In many larger companies having tabu-

lating or bookkeeping machine systems, the pegboard is ideal for use on confidential payrolls.

Another device useful in the small office is the edge punched card. This is a document form which provides a means for recording numerical data on the card by notching holes along the side of the card. By the use of a needle, the cards can be sorted and re-sorted into various classifications for summarization of data. Prominent applications for the device include sales, labor and cost distributions. The edge punched card can be characterized as the poor man's punched card. Where punched card versatility is required but volumes do not warrant the investment required in electric tabulating equipment, the edge punched card may be the answer. Roll up peg strips and a combination of peg strips and edge punched cards are variations worthy of consideration.

Another innovation to accounting applications is the use of microfilm, not as a part of a records retention program but as an active partner in the processing of accounting data. Several applications have recently been publicized, one of which relates to cycle billing. In this system, the sales tickets, when recorded on the customers' statements, are microfilmed and the tickets are mailed to the customer, leaving the store with only a microfilm record of the transaction. This eliminates the original preparation of a retained copy of the sales ticket and eliminates a bulky and costly filing problem. In another application, employees' clock cards are microfilmed, which permits the timecards to be destroyed shortly after the preparation of the payroll, again eliminating a bulky storage problem. The economical use of this application is, of course, dependent upon minimum need for access to the microfilmed record and a filing system which makes the microfilmed record readily accessible.

The cost-conscious office executive, in addition to remaining constantly alert to new equipment development, should be familiar with cost-reducing applications of existing equipment. Ingenious uses of many items of office equipment are constantly being developed with the objective of reducing costs or improving services.

Dictating equipment, for example, has been adapted to many interesting office applications. The many fine, low-priced dictation machines now on the market are gaining increasing acceptance as a means of not only increasing executive productivity but also reducing stenographic costs. The busy doctor or professional man now frequently dictates a statement of charges for each patient in a few seconds for later transcription onto an invoice by his secretary, increasing the portion of his valuable time available for treating patients. In one steel mill, an application of dictating equipment was developed with the objective of reducing paperwork by foremen. A means was provided for foremen to transmit certain data by telephone from any point in the plant to centrally located dictating machines. A stenographic corps at the central point then prepared move orders, requisitions and other documents.

Another equipment field in which technological progress has been outstanding has been the copying equipment field. Many companies are competing with machines utilizing different processes, all of which will produce copies of documents but have varying characteristics. The Diazo process, for example, is exceptionally fast and inexpensive but has the limitation that the original copy must be on translucent paper, making this process unsatisfactory for such tasks as mak-

ing additional copies of incoming correspondence. It is well adapted, however, to various accounting processes where the original media can be controlled.

The Photocopy process, on the other hand, is relatively expensive (8 to 10 cents per copy) but can produce faithful copies of almost any type of document. It is very useful in an office for copies of correspondence, accounting schedules, charts, and other uses. Public accounting firms find a very practical use for a photocopy machine for making copies of revenue agents' reports and various charts and graphs.

The Thermo-Fax is an excellent process producing less costly copies than the Photocopy process but has the limitation that certain colors do not reproduce well.

Xerography is a particularly significant process in large office operations. This process is similar to photocopying but can make offset and spirit masters, positive-working offset plates, and translucent copies for the Diazo process. It can enlarge and reduce. Claims of annual cost savings of hundreds of thousands of dollars have been made for this process in the automobile industry alone. Among the publicized applications are inexpensive blueprint reproduction and processing changes in parts lists and catalogues. It is also used in one major automotive company in the consolidation section where financial statements of individual plants and divisions are pegstripped, crossfooted to produce division or company totals, and then through the Xerography process, a master is produced through which consolidated statements are rapidly prepared for distribution to executives. This company claims that a worldwide consolidation can be made in two and one-half hours and that delivery of financial statements has been expedited. This process has been credited not only with a cost savings but also with speeding the delivery of financial statements.

IMPROVEMENTS IN REPORTING TO MANAGEMENT

Recent advances in office equipment, including improved computing and data processing equipment, have made it economically feasible to supply management with current facts for making business decisions on a timely basis. The ultimate profit contribution available from improved data for decision making, usually far exceeds the profit contribution available from clerical cost reduction.

High-speed computing equipment has brought into focus the responsibility of office management for organizing data as a part of the decision-making process. This process can be simply illustrated by considering the recordkeeping problems in controlling a nation-wide parts inventory of several hundred thousand items maintained throughout the country in regional warehouses. Under a manual system, hundreds of clerks are employed in maintaining inventory records, both in the field warehouses and in the central procurement office. Under an integrated system, daily transactions from all parts of the country are transmitted to a central computing activity where a large scale electronic computer processes each day's transactions. Inventory records are updated, balances remaining after each day's transactions are compared with predetermined maximum and minimum limits, and a written report is prepared for each part requiring some executive action, such as replenishment orders and disposition of overstocks. Under this system, the executives concerned are promptly advised of the particular parts that require executive action and

are not distracted by reports on the tens of thousands of items where no action is required.

The foregoing example illustrates the technique that has come to be known as "management by exception." This technique is based on the premise that management is not concerned with the tens of thousands of record cards that require no action; but management is very intimately concerned with the smaller number of records that indicate a need for replenishment action or some other management decision. Although the illustration given is based on the experience of a very large company utilizing an electronic computing system, the technique of "management by exception" is also applicable to small companies. In most instances, management is not concerned with an aged listing of accounts receivable balanced to a control account; but management is interested in the particular accounts where customers have not paid their bills when due or where shipments exceed authorized credit limits. Management is not concerned with expenditures which are within authorized limits; but it is concerned with expenditures which exceed the budgeted amounts.

An effective program for office mechanization demands that the system be designed to produce a required answer. Standard data patterns should be established and reports should be designed which provide management with the information required to assist in making decisions. In many instances, greater cost reductions are available through eliminating reports which do not lead to management decisions than through finding faster ways of producing unused information.

An additional consideration in systems design that is not essentially different from the foregoing, is the consideration of timeliness. Data required for management decisions are only useful for that purpose if the data are in the hands of the proper persons prior to the time when a decision must be made. In many instances, mechanization of office procedures can be justified solely on the basis that mechanized methods can process data and prepare reports in a timely manner. It will be readily recognized that if a payroll cannot be processed in time to have checks available for employees on pay day, an equipment investment would be warranted regardless of cost considerations. It is sometimes not so easily recognized that a delay in processing invoices or customer statements may delay the receipt of collections from customers. Undue delays in processing payments to vendors may be costly in terms of discounts lost and may even impair the company's credit rating. Many companies have installed mechanized systems, and many more should be installed, for the primary purpose of expediting informative reports to management on a timely basis. Certainly stale financial facts are just as distasteful as stale bread and just as uninteresting as last week's newspaper. Specially designed systems of management reports are a total failure unless essential facts reach management in sufficient time for management to do something about them.

APPLYING SCIENCE TO SOLUTION OF BUSINESS PROBLEMS

An important recent development in the science of business management has been the application of the research techniques of the physical sciences to the solution of business problems. This is commonly referred to as *operations research.* Persons trained in the sciences have combined their efforts to seek out the best solution to particular problems. Groups of scientists have applied their analytical tech-

niques and skills to solving many diverse problems in the fields of production, marketing, advertising, shipping, inventory control, warehousing and other business fields. The results of such scientific research techniques have been to translate particular problems into a quantitative form capable of mathematical solutions. The resultant solutions, in many instances, have produced remarkable savings but the mathematical computations involved in arriving at the solutions are sometimes so complex that the answer can be ascertained only after months or years of calculation on conventional calculating equipment. Now such calculations can be performed in a matter of hours or minutes using high-speed electronic computing systems.

A typical example of a business problem which lends itself to mathematical solution is commonly referred to as the transportation problem. Let us assume that a particular company has ten plants and ten products manufactured by the company. Each of the ten plants is capable of manufacturing each of the ten products. Transportation costs of the finished product to the company's sales outlets will be minimized by manufacturing the ten products in the manufacturing plant nearest to each sales territory. However, this may result in short runs of each product at all plants with a resultant increase in over-all production costs. Maximum productive efficiency can be achieved by producing a different product in each of the ten plants, but this saving in production costs is obviously at the expense of increased transportation costs. Additional savings may be made by programming longer runs of specific products and stock-piling the quantities produced. This, however, introduces a factor of additional cost related to investment in inventories, obsolescence, etc. This problem can be reduced to mathematical form through evaluating the incremental cost of transportation, investment and production costs for each of the ten products in each of the ten plants.

The type of situation outlined in the transportation problem is one that faces companies with multi-plant locations. In most companies, the production control manager or some other responsible executive sets up schedules of production that, based on his judgment and past experience, produce economical quantity runs, minimum investment in inventories and minimum transportation costs. However, as schedule decisions are not made by the use of refined scientific formulae, the result achieved is not the best possible solution to the specific problem. Scientific techniques applied to transportation and other similar problems in many companies have resulted in solutions that are demonstrably better in terms of cost reduction and contribution to profit than the solutions arrived at by other processes.

Some of the best work in this field has been done on inventory-type problems involving the measurement of opposing costs as, for example, the excessive cost of short production runs as opposed to the cost of an increased investment for carrying inventories. A variation of this problem is found in the studies which some airlines have made to determine the frequency with which training schools for stewardesses should be held. In this problem the reduced unit costs resulting from larger training classes have been weighed against salary cost of waiting time until excess trainees are assigned.

Among those most skilled in the field of electronic computers and management sciences, many believe that the real benefit of computers to busi-

ness will be increases in profits resulting from the scientific solutions of common business problems. Increases in company profit from mathematical techniques may easily exceed increases in profit expected from reducing clerical costs. This is another contribution of the electronic computer to modern business management.

Applied science is a tool of modern management that is not restricted to large companies who own or rent electronic computers. Small companies as well as large have available to them for use on scientific problems the computer facilities of service bureaus and research centers. The analysis of data and the subsequent development of mathematical formulae require specialized knowledge and skill. While large companies may employ research groups skilled in these techniques, smaller companies can avail themselves of similar services on a fee basis from many accounting and consulting firms, as well as university research centers.

MANAGEMENT ACCOUNTING

Management accounting is any aspect of accounting which provides the means of effective control of business activities. All accountancy operations have a direct or indirect influence on the conduct of a business so that the greater part of accountancy is concerned with management accounting. What is new is the desire among non-accounting management to make use of accounting information. This springs from the growing realization that accounting data are invaluable for control purposes and policy-making. The essential function of management accounting is to assist the forward planning of business activities and to evaluate the end results of such planning.

E. C. D. EVANS, "Management Accounting,"
THE ACCOUNTANTS JOURNAL [England], June 1960

New York State Tax Forum

Conducted by Peter Elder, CPA

REAL ESTATE CORPORATION

To be classified as a real estate corporation, it is absolutely necessary that a corporation be wholly engaged in real estate operations. Classification under Section 182 will be lost where substantially all of the stock of a real estate corporation is owned or controlled by a business corporation subject to tax under Article 9-A, and the business corporation uses or occupies in its business a material part of the property of the real estate corporation. Thus, where stock of both corporations is owned by the same shareholders, reclassification can result. However, there are situations where ownership by common interests will not result in reclassification.

Suppose that the stock of a real estate corporation is owned 80 percent by a father and the remaining 20 percent equally by his two sons; also, that a business corporation subject to tax under Article 9-A, stock of which is owned 50 percent by each of the sons, occupies the property of the real estate corporation in its business. Are both corporations owned or controlled by common interests? The answer is *no,* or at least so the Court held *In the Matter of Application of H. M. Vinard, Inc.* v. *State Tax Commission,* decided by the Supreme Court, Appellate Division, Third Judicial Department, March 18, 1960. The facts of the case are as stated above; the record did not include any information as to officers, directors or management of the corporations.

The Tax Commission alleged that since the stock of the two corporations was owned or controlled directly or indirectly by the same interests within the meaning of Section 211.4 of Article 9 of the Tax Law, the real estate corporation must be taxed as a business corporation under Article 9-A. The Court cited the Commission's regulations for the purpose of defining "substantially all" stock, and commented to the effect that, while a determination must be made on the basis of facts in each case, ordinarily the beneficial ownership or control means 95 percent or more of the issued and outstanding capital stock entitled to vote for the election of directors, and that such ownership will satisfy the requirements of the statute.

The Court stated: "It is obvious that the stock ownership in the case does not meet the requirements of the Commission's own regulations—not necessarily controlling—but in this case the only testimony to substantiate the determination. There is no showing as to who were the officers, directors, who managed, operated or controlled the corporations, nor any other factors as to either corporation, which would tend to sustain the theory of the Tax Commission." Thus, since stock ownership

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and control, the determining factors, were not shown where the real estate corporation was only 20-percent owned by the interests of the business corporation, and the major interest in the real estate corporation had no stock ownership in the business corporation, assessment of the real estate corporation under Article 9-A was annulled.

This case illustrates quite clearly that the question which must be answered in each situation is whether the real estate corporation is owned or controlled by common interests with that of a business corporation subject to tax under Article 9-A; and while the Commission's regulations carry great weight, as the court said, "they are not necessarily controlling."

EMPLOYER'S WITHHOLDING STATEMENT

Every employer who is required to deduct and withhold New York State income tax must also furnish to each employee a withholding statement on Form IT-2102. The statement must be distributed on or before February 15 relative to earnings of the preceding calendar year or, if employment is terminated before the close of the calendar year, within thirty days after the last payment is made. It must show the amount of wages paid by the employer to the employee during the calendar year, the amount deducted and withheld as tax, and other information as required on such form.

As a result of inquiries, the State Tax Commission recently issued a ruling concerning the acceptability of reproduced Forms IT-2102, either separately or in combination with the Internal Revenue Service withholding tax statement, Form W-2. The ruling is very specific in that it covers the color and quality of ink and paper, typography, format, dimensions and construction, carbon paper, and instructions as to sets combined or not combined with federal forms.

The ruling further advises that "all copy must be approved by the Income Tax Bureau, Albany 1, N. Y. An approved number will be assigned to approved copy." While very few employers will print their own Form IT-2102, for those who do, strict compliance will most likely be required in accordance with the ruling. Furthermore, clients should be certain that the form they purchase is an approved copy. Here is an opportunity to help your client by discussing the requirements of the ruling so as to prevent a possible rejection of copy by the State next year.

TRANSFER OF PROPERTY AS AN INCIDENT TO DIVORCE

An interesting question is presented where property is transferred by one spouse to another as an incident to the divorce of the parties. Assume that husband and wife, both being New York residents, decide to obtain a divorce. Prior to the divorce the parties enter into a written agreement which provides that the husband will transfer to his wife, one-half of all his property, the division of which is to be based on the market value on the date of transfer. Assume, further, that the husband has securities with a market value of $500,000 but with a zero tax basis; that he transfers $250,000 of the securities to his wife in accordance with a written agreement in settlement of his wife's marital rights; and that a divorce is obtained immediately thereafter. What is the tax effect to the wife and to the husband?

Section 2516 of the Internal Revenue Code of 1954, as amended, indicates that where a husband and wife enter into a written agreement relative to their marital and property rights and divorce occurs within two years

thereafter, any transfers of property, etc., to either spouse, pursuant to such agreement, in settlement of his or her marital or property rights shall be deemed to be transfers made for a full and adequate consideration in money or money's worth. Thus, it appears that the husband will not incur any gift tax liability on the transfer. As a matter of fact, Regulations Section 25.2516-1 states specifically that such transfers are exempt from the gift tax.

What about income tax liability? It would appear that when the husband transferred securities to his wife, he entered into a taxable transaction under Section 1001 of the Internal Revenue Code since the transfer would probably be considered as a disposition of property within the scope of that section. Furthermore, the husband would probably be deemed to have received consideration for the transfer — relinquishment by the wife of all rights to support and maintenance and to share in his property at his death. On this basis, assuming the securities were capital assets in the hands of the transferor (husband), the gain thereon — in our example, \$250,000—would be taxed at the capital gain rate. The wife's basis for the securities would presumably be the market value on the date of transfer. The above would appear to be the tax effect for federal purposes, and presumably for New York State tax purposes, if the transaction occurred in 1960, under Article 22 of the New York State tax law.

(During the interval between the writing of this department and the return of the proof from the printer, the Sixth Circuit reversed the Tax Court in *Marshman,* 60-2 USTC 9484. In that case, when the parties remarried, the husband transferred stock to his wife, reserving to himself an option to buy back the stock for \$40,000, the fair market value at the time of trans-

fer. As part of the divorce settlement, the husband gave up his option to reacquire the stock which had increased in value to $400,000. While the Tax Court indicated that the husband had realized a gain of $360,000 on relinquishment of the option, the higher court disagreed. The Circuit Court indicated that the release by the wife of her rights against her husband could not be measured. Since the release involved so many uncertain and emotional factors, it was not possible to assign a fair market value to the release. Thus, under such circumstances, the value of what the husband relinquished was no criterion of the value he received; therefore, there was no taxable gain since the property received by the husband did not have a value readily determinable.)

However, suppose the transaction had occurred in 1959 or an earlier year —what would the tax effect have been for New York State purposes? The New York Tax Law does not have any section comparable to Section 2516 of the Internal Revenue Code regarding transfers of property pursuant to written agreements made in contemplation of divorce proceedings. Therefore, it would appear that the husband would have no New York State income tax liability in connection with the transfer of property to his wife. Also, the transfer would be construed as a gift and the basis of the securities received by the wife would be determined in accordance with the rules applicable to gifts. Since there is no gift tax in New York, the husband would not have incurred a gift tax liability.

In view of the above, it is suggested that readers review their files in case opportunities exist for filing claims for revision of New York State income tax for 1959 and prior years.

GROSS RECEIPTS TAX— ASSESSMENTS AND REFUNDS

Last month this department reviewed the decision of the Court of Appeals in the *U. S. Steel Corporation* case concerning holding companies and their exemption from the financial business tax, and the special bulletin issued by the Special Deputy Comptroller of the City of New York in connection with that decision. Several readers have inquired concerning the filing of claims for refund for taxes paid for calendar years prior to 1959. Therefore, a review of the period for assessment and refunds seems appropriate at this time.

As a general rule, the law states that no assessment of additional tax shall be made after the expiration of more than three years from the date of the filing of the return. An exception to the general rule exists where no return has been filed, or in the case of filing a wilfully false or fraudulent return with intent to evade the tax. The law also provides that the three-year period may be extended if the taxpayer consents in writing to the extension.

To obtain a refund of taxes erroneously, illegally or unconstitutionally collected by the Comptroller prior to April 21, 1957, it was necessary for the taxpayer to have paid such taxes under protest in writing. In addition, the application for revision of the tax must have been filed with the Comptroller within one year from the date of payment of the tax. The Laws of 1957 amended Section B46-7.0 of the Tax Law so as to provide that it is no longer necessary to have paid the tax under protest in order to file an application for revision of tax. It continued the requirement that the application for revision must be filed within one year from the date of payment of the tax. The amendment was effective as of July 16, 1957. It would appear that unless applications for revision of tax were filed with the Comptroller within one year from paying the tax for the calendar year 1958, the permissible filing period would have expired.

Accounting and the SEC

Conducted by Louis H. Rappaport, CPA

SEC AMENDS RULE FOR USE OF FORM S-9 AND DEFINITION OF "FIXED CHARGES"

Form S-9 is a relatively short form of registration statement. Its use is limited to seasoned companies who meet the requirements, and it can be used only in connection with offerings of non-convertible debt securities. Among the other requirements are specified ratios of earnings to fixed charges.

When Form S-9 was promulgated it contained a rather unusual definition of "fixed charges." In its most recent form the term "fixed charges" was defined in Form S-9 as follows:

> The term "fixed charges" shall mean (i) interest and amortization of debt discount and expense and premium on all indebtedness, (ii) *an appropriate portion of rentals under long term leases,* and (iii) in case consolidated figures are used, preferred stock dividend requirements of consolidated subsidiaries, excluding in all cases items eliminated in consolidation. (Emphasis supplied.)

The phrase "appropriate portion of rentals" caused some consternation when Form S-9 was first issued. Accountants wondered what was contemplated by the phrase. As the result of inquiries and from working with the form, accountants learned that only a portion of rentals paid was considered to be a fixed charge, namely, the interest factor on the cost or value of leased property. The interest factor represents the owner's profit on his investment plus his interest charges, and this is the portion of the rent which is considered to be "an appropriate portion."

The determination of what constitutes "an appropriate portion" of the rent in a given case is likely to be a difficult task, and, in many cases, it has to be estimated on a somewhat arbitrary basis. Consequently, the SEC has had under consideration a proposal to amend the definition of "fixed charges" so as to establish a definite formula which may be used in determining the appropriate portion of rentals representing the interest factor in order that a prospective registrant may determine with reasonable certainty whether it is qualified to use Form S-9.

The SEC has amended the definition of "fixed charges" along the lines of the proposal referred to above. The amendment changes the test from "an appropriate portion of long term rentals" to "one-third of all rentals re-

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ported in Schedule XVI* or such other portion as can be demonstrated as representative of the interest factor." The limitation of rentals to "long term leases" has been dropped because of the substantial difference of opinion as to the definition of a "long term lease" and because the presence of the interest factor in rentals is not dependent upon the rental contract extending over any given period of time.

It has been suggested that "delay rentals" paid on leaseholds to retain mineral rights before development of leased acreage are not in the nature of ordinary rental for the use of property. Delay rentals or other items included in rentals in Schedule XVI which can be shown to contain little or no interest factor may properly be excluded under the alternate treatment.

The text of paragraph (c)(2) of General Instruction A as amended reads:

> (2) The term "fixed charges" shall mean (i) interest and amortization of debt discount and expense and premium on all indebtedness, (ii) one-third of all rentals reported in Schedule XVI, or such other portion as can be demonstrated as representative of the interest factor in the circumstances of a particular case (if an alternative basis is used, explanation should be set forth in the statement required by Exhibit 5 of the Instructions as to Exhibits), and (iii) in case consolidated figures are used, preferred stock dividend requirements of consolidated subsidiaries, excluding in all cases items eliminated in consolidation.

The amendment became effective on August 1, 1960.

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* Note 5 to Schedule XVI provides that "If the aggregate amount of rents and royalties is not material, a statement to that effect will suffice."

Administration of A CPA Practice

Conducted by MAX BLOCK, CPA

LONG-RANGE PLANNING FOR GROWTH BY NEW PRACTITIONERS

New practitioners are, of course, greatly concerned with achieving a steady growth of their practice. The following are some preliminary considerations in dealing with this objective:

1. The generation of growth must not be in violation of our professional codes of ethics which prohibit advertising and solicitation and impose other limitations.

2. The dynamism of the principals, their competence, their progressiveness, and their confidence-inspiring personalities are vital to success.

3. The territory served or the field of specialization must have possibilities for growth.

4. The present status of the firm as to number and type of clients, the regard in which it is held by clients, and its status in the business, credit, and allied professional community, are factors that influence the rate of growth. Ordinarily, a firm starts out like a heavily laden freight train—a slow, creeping take-off—but as it accelerates it becomes easier to pick up added speed. Thus, a larger firm, having a broader base on which to build, should have a more rapid acceleration than a small one, if all the necessary factors are present.

Growth and economic success are usually associated with:

1. Increase in number and quality of clients.
2. Growth in size of the organization—partners and staff.
3. Increase in fee scale.
4. Increase in partners' earnings and in staff salaries.
5. Enhancement of the firm's reputation.

How can the small firm achieve these objectives? Here are a few brief, practical thoughts, the efficacy of which is dependent on the preliminary considerations cited initially.

Growth comes from within and without. From within, one can look to natural client growth through expansion of business, absorptions of other companies, and new ventures. From without, one can look to recommendations by pleased clients and by bankers, lawyers and other adjuncts who are favorably impressed. Personal prominence in philanthropy, civic affairs, fraternal and religious groups, and in

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trade organizations, is another legitimate means of developing contacts and clients. The purchase of practices of retiring or deceased practitioners is a method of artificial growth as is a merger of accounting firms.

The quality of the clientele will improve gradually as the firm's own ability to serve them is recognized. This will develop as services are upgraded and attract notice. Management advisory services can play a major role in the attraction of favorable notice. Aid in such areas as profit improvement, financing, economic counselling, and in many other business and personal situations will eventually yield benefits. Outstanding reports—adequate in content, meaningful to clients and credit grantors, and conforming with the highest professional standards—will yield dividends. Good tax advice in planning and in tax return preparation will make loyal friends and boosters. Finally, good service and professional-like relationships should reach the attention of an ever widening circle.

A professional firm should not expect such fast, dynamic growth as is possible in business fields. Rather, it should grow steadily and sturdily, somewhat like a tree, adding some growth each year and broadening its base for further growth upward.

An accounting organization, however small, must strive unceasingly for excellence in work and in service. This requires the selection of the best partners and men available and such compensation and working conditions as will hold them. Outstanding staffmen should be made junior partners, to hold them and to advance and perpetuate the firm.

Specialization should be encouraged. In a two-partner firm, for example, one might concentrate on taxes and the other on management services. If there is one staffman in the organization, he too might develop expertness in some field of importance to the firm. Expertness can lead to the writing of articles for trade publications and to addressing groups—a very proper form of promotion if carried out within professional limits.

Every opportunity should be availed of to meet clients' bankers and attorneys. Similarly, accountants should be very willing to sit in on client conferences with other business and professional men. The accountant who distinguishes himself in such circles surely is a "growth professional."

Veteran practitioners are solicited to submit their own rules for success in public accounting, and actual case experiences will be most welcome for publication. This should be an opportunity for those who have achieved a measure of success to give a helping hand to the young practitioners in the public accounting profession.

Federal Taxation

Decisions and Rulings—RICHARD S. HELSTEIN, CPA

Commentary —Committee on Federal Taxation
Chairman, ARTHUR J. DIXON, CPA

DECISIONS AND RULINGS

GIFT VS. INCOME

In June 1960 the Supreme Court handed down its decisions in three cases involving the much litigated question of what constitutes, to the recipient, a "gift" which is not includible in taxable income. The first case, *Com.* v. *Duberstein,* involved the transfer of a Cadillac by a corporation to Duberstein, because he had recommended to the donor, business in which Duberstein's own company was not interested. The second, *Stanton et al.* v. *U. S. A.,* involved the payment by a corporation to its retiring president of an amount slightly less than his annual salary, payable over ten months. The third case, *U. S.* v. *Allen Kaiser,* on which a separate decision was handed down, involved the question of whether strike benefits received from a labor union in the form of food, clothing and rent payments, were taxable income or gifts.

The Government requested the Court to provide a test of a "gift" to serve as a judicial standard for the lower courts, and suggested the following: *Gifts should be defined as transfers of property made for personal as distinguished from business reasons.* This the Court declined to do, holding that the determination is a factual one and as such is within the province of the trial court, and that the variance of facts and intents obviate the efficacy of a general rule. The Court rejected the Government's contentions that corporations can only expend their assets for business purposes and that "what is a deductible corporate expense on one hand, must be taxable income on the other," explaining that the first principle depends on the laws of the state of incorporation, and the second would involve issues not before the Court considering the question, i.e., the conduct and tax liability of the transferor corporation.

Having declined to promulgate a judicial definition of "gift," the Court ruled on each case individually. In the *Duberstein* case, the Tax Court's findings that the Cadillac constituted compensation for past services or an inducement for future services, were upheld as not being "clearly erroneous."

The *Stanton* case was remanded for further findings since there was not sufficient information in the District Court's decision to enable a determination by the Supreme Court as to whether the decision that the payment to Stanton was a "gift" was erroneous or not.

In *Kaiser,* the Court accepted the jury decision that the strike benefits were a gift since: they were given to

both union and non-union strikers; they were measured by the individual recipient's needs and requirements; and the gifts were dependent upon whether the striker could obtain state unemployment compensation or local assistance benefits. Also, extremely important, was the fact that no conditions were attached to the aid rendered.

FOREIGN PERSONAL HOLDING COMPANY INCOME NOT TAXED WHERE IRS PREVENTED DISTRIBUTION

The taxpayer, a U. S. citizen, acquired 95 percent of the stock of a foreign personal holding company in partial payment of fees and advances due to him by the former stockholders. At the time he acquired title in 1951, the stock was in the possession of the Collector of Internal Revenue, having been pledged by the former owner as security for unpaid taxes of both the former owner and of the corporation itself.

In 1951, the taxpayer requested the Government's permission to pay from the foreign personal holding company, a dividend in the amount of that corporation's "Supplement P net income." The request was refused. Similar requests were refused for 1953 and 1954. Nevertheless, the Internal Revenue Service asserted deficiencies against the taxpayer under Section 337, IRC 1939 (similar to Section 551, IRC 1954), based upon the undistributed income, and was upheld by the Tax Court (32 TC __ No. 1).

The Fourth Circuit Court of Appeals reversed the Tax Court, holding that the statute was not to be literally interpreted where its effects were clearly not the intent of Congress. The Court explained that the purpose of the statute was to prevent the accumulation of earnings in foreign personal holding corporations not subject to U. S. taxes. Pointing out that the section was applicable only where control of the corporation and, concomitantly, its dividend payments were in the hands of a group of not more than five U. S. stockholders, the Court implied that where the controlling shareholders were powerless to effect a distribution, the section was not intended to apply. Here there was no "inaction of the United States group"; quite the converse—the Government itself prevented the distribution. Thus, the tax was not to be asserted (*Alvord et ux* v. *Com.*, CA-4, 4/26/60.)

The Court distinguishes this situation from that involving blocked currency in the decision in *Elder* v. *Com.* (CA-2, 1942; 138 F(2d) 27), despite the opinion there, which is quoted below:

> We do not agree with taxpayer's argument that inability to expend income in the United States, or to use any portion of it in payment of income taxes, necessarily precludes taxability. In a variety of circumstances it has been held that the fact that the distribution of income is prevented by operation of law, or by agreement among private parties, is no bar to its taxability. See, e. g., *Heiner* v. *Mellon*, 304 U.S. 271, 281 (38-2 USTC par. 9311); *Helvering* v. *Brunn*, 309 U.S. 461 (40-1 USTC par. 9337). That the result under the statute here before us may be harsh is no answer to the government's position; the purpose of Congress was to deal harshly with "incorporated pocketbooks," and the motive of a particular taxpayer who has such a "pocketbook" we have held to be irrelevant. *O'Sullivan Rubber Co.* v. *Commissioner*, 120 Fed. (2d) 212, 213 (C.C.A. 2) (42-1 USTC par. 9315), we said; "It is apparent that the decision of the Board has brought about a harsh result by imposing a surtax, to say nothing of the penalty for failure to file a return, upon a corporation which had no net income to distribute; but if it finds itself, because of the way it was organized and did its business, within the scope of a

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statute primarily designed to make the failure to distribute actual net income too expensive to be worth while and was, therefore, taxed when it did not in fact do what the statute was aimed to discourage, it must endure its misfortune as best it may."

Instead, the Fourth Circuit relies on its holding in a previous case (*Marsman* v. *Com.* (CA-4, 1953, 205 F(2d) 335), that Congress did not intend that the sections of the Code dealing with foreign personal holding companies were to be applied literally.

AMORTIZATION OF BOND PREMIUMS

The Internal Revenue Service has announced in TIR 233 (5/27/60), that it will not follow the decision in *U. S.* v. *Parnell and J. H. Reed, Jr.* (CA-6, 1960, 1272 F(2d) 943) which held that taxpayers could compute the amortization of bond premiums on fully taxable bonds on the basis of the difference between the purchase price and the "special" redemption price at which the bonds could be called on 30 days' notice. The IRS maintains that the "special" redemption price was "dependent upon contingencies which precluded any reasonable advance ascertainment of a date of call at the 'special' redemption price," and that, therefore, the "general" redemption price should be used. (See Rev. Rul. 56-398.)

TIME FOR DEDUCTION OF CONTESTED REAL ESTATE TAXES

In 1949, Consolidated Edison received a proposed assessment of real estate taxes by New York City of $100X. It protested the assessment, admitting liability of only $85X. However, when a hearing in that same year upheld the City's assessment, the Company paid the $100X under protest, and instituted certiorari proceedings to recover $15X. In 1951, the certiorari proceedings were settled fixing the tax at $95X, and establishing an overpayment of $5X which was duly refunded.

Since the taxpayer kept its books on the accrual basis, the question arose as to how this series of transactions was to be reported. The Government claimed that the taxpayer should deduct $100X in 1949 and report $5X as income in 1951. The taxpayer's position was that only the liability acknowledged of $85X accrued and should have been deducted in 1949, and that the additional liability of $10X was deductible in 1951 when the case was decided.

The Court of Appeals agreed with the taxpayer, relying on the Supreme Court's decision in *Dixie Pine Products Co.* v. *Com.* (1944, 320 U. S. 516) and *Security Flour Mills* v. *Com.* (1944, 321 U. S. 281), which held that where liabilities are contingent or contested, they cannot be accrued and deducted since they have not been established both as to fact and amount. Acknowledging that the instant case was distinguished from the two cited above by virtue of the payment under protest which did not exist in either of those cases, the Court holds that this distinction would not nullify applicability of the doctrine promulgated. It points out that a payment *per se* does not embody the characteristics which determine it to be a deduction since it may constitute a capital expenditure, a deposit or a prepaid expense which are not deductions. (*Consolidated Edison of N. Y. Inc.* v. *U. S.*, CA-2, 5/25/60.)

Of interest is a point raised in a dissenting opinion, that the Court's ruling "leaves open to a taxpayer opportunities for manipulation through self-serving appraisals." The majority dismissed the objection, reasoning that the question of bona fides is always present whether or not there has been payment. However, of particular interest in the "tax accounting versus

accepted principles" controversy is the following paragraph from the dissenting opinion:

Apparently accountants and at least some tax lawyers agree that the Commissioner has not been appropriately hospitable to the precepts of accrual accounting and applaud tentative judicial steps toward accepting such precepts. See, e.g., Behren, *Prepaid Income-Accounting Concepts and the Tax Law*, 15 Tax L. Rev. 343 (1960), discussing *Bressner Radio, Inc.* v. *C.I.R.*, 2 Cir., 267 F(2d) 520 [59-2 USTC par. 9496]. For my part I would not disagree and think that within limits the trend to follow accounting ideas is desirable as bringing tax and business practices mutually into line. But I do feel it must stop short of delivering control of the revenue to the accountants. For accounting is not an exact science; and corporate balance sheets must deal with many fluid items, representing of course much factual information, but also a certain amount of prophecy, of hope, and of sheer argumentation. Because of this, because also the accountant does owe the duty of loyalty to his client, the result will naturally reflect the needs and desires of the client more than the appropriate demands of the tax collector, who not only must collect all the revenue due, but must hold the balance fairly and without discrimination among taxpayers. And the present holding, which goes beyond anything yet in the books, seems to me to exceed proper bounds in committing final adjudication as to the revenue to corporate accountants.

TAX-EXEMPT BOND DISCOUNT

The Internal Revenue Service has ruled that the gain on redemption or sale of state and municipal bonds issued at a discount is equivalent to interest to the extent of the discount. Since Section 103(a)(1) excludes interest on such bonds from gross income, the discount is not taxable in the year realized. However, this applies only to bonds purchased directly from the municipality and is referred to as "issue" discount. Where bonds which were not originally issued at a discount are purchased from a dealer at less than par, the discount is not considered compensation paid by the municipality for the use of funds, but is merely "market" discount, and as such is taxable as a capital gain upon sale or redemption. (Rev. Rul. 60-210.)

COMMENTARY

RAPID DEPRECIATION FOR LEASEHOLD IMPROVEMENTS

An inquiry has been received from a member of our Society containing an interesting set of facts concerning rapid depreciation of leasehold improvements.

The facts, briefly stated, are that a lessee of a retail store made substantial improvements to the premises. When the work was completed, the lease had ten years to run. The member inquired whether the 200-percent declining-balance method of depreciation could be used for the purpose of writing off the improvements.

Regulations Section 1.167 (a)-4 provides for the recovery of the cost of improvements on leased property either through allowances for depreciation or amortization. If the useful life is equal to or shorter than the remaining period of the lease, the allowances shall take the form of depreciation under Section 167. If, on the other hand, the useful life is longer than the remaining period of the lease, the allowances shall take the form of annual deductions in an amount equal to the unrecovered cost of such improvements, divided by the number of years remaining of the term of the lease. Such deductions shall be in lieu of allowances for depreciation. Ref-

erence is made therein to Section 162 and the regulations thereunder.

Regulations Section 1.162-11 (b) (1) similarly provides that if the life is longer than the remaining term of the lease, the annual deduction shall be made under Section 162, and is in lieu of depreciation. If the life is equal to or shorter than the lease, the annual deduction is depreciation and shall be claimed under Section 167.

Inasmuch as the double-declining method may only be claimed under Section 167, it is available only if the deduction is depreciation. Accordingly, under the stated facts, the rapid depreciation can be used only if the leasehold improvements have a useful life of ten years or less.

It should be noted that under Section 178, a lessee who begins improvements on leased property after July 28, 1958 may be required to include renewal periods, as well as the initial term of the lease, in the period over which the improvements may be written off. In that event, it may be that the extended period will be equal to or greater than the life of the improvements, in which event rapid methods of depreciation may be used. Under such circumstances, the requirement of using the renewal period in determining the taxpayer's write-off with respect to the leasehold improvements can be an advantage rather than the detriment which it is often considered.

EFFECT OF TAX-EXEMPT INCOME ON TERMINATION OF ESTATE OR TRUST

In the year of termination of an estate or trust, substantial expenses, such as legal fees and trustees' or executors' commissions, are often incurred. Usually these expenses will exceed the income for the year and, under Section 642(h), such excess will be allowed as a deduction to the beneficiaries succeeding to the property of the estate or trust.

Care must be taken to avoid a possible pitfall that may arise in the last year, particularly in the case of an estate. It often happens that the assets retained by the estate in its final period are safe, fixed-income obligations, such as short-term U. S. Treasury or municipal bonds retained as a reserve for possible liabilities such as an estate tax deficiency. Suppose that the asssets consist only of municipal bonds, so that the only income received by the estate is tax-exempt interest. What effect will that have on the deductibility of the final year's expenses, including the amount in excess of the tax-exempt income?

Regulations Section 1.265-1(c) provides: "If an expense or amount otherwise allowable is indirectly allocable to both a class of nonexempt income and a class of exempt income, a reasonable proportion thereof determined in the light of all the facts and circumstances in each case shall be allocated to each." Normally, these expenses are allocated to tax-exempt income based on the proportion of tax-exempt income to the total of all of the items of gross income, including tax-exempt income.

Applying this rule to the above facts where the estate's only income in its final year consisted of tax-exempt income, would all of the expenses be attributable to it and disallowed? Such a result would eliminate any Section 642(h) deduction to the beneficiaries. The answer to this question cannot be found either in the Code or Regulations. Therefore, it would seem advisable to arrange the affairs of the estate or trust in a final year so that if expenses are in excess of income, tax-exempt income is kept to a minimum.

HEAD OF HOUSEHOLD STATUS WHERE PARENTS ARE INSTITUTIONALIZED

An individual can qualify as a "head of a household" and thus obtain the benefits of limited income—splitting if he contributes more than half of the cost of maintaining a household which is the principal place of residence of certain specified individuals. This residence, in the case of a dependent parent, need not be his home nor is it necessary that the individual taxpayer reside there. In fact, it can be a boarding house or even a room in a hotel.

Temporary absence of a parent from such household will not disqualify the individual taxpayer from claiming this status; but as a general rule the parent must occupy the premises for the entire year. Thus, an individual who has a parent living with him can qualify as a "head of a household." Moreover, if he maintains separate and distinct households for the parent and himself, he can also qualify. But what happens if instead of maintaining a separate apartment for a parent, the taxpayer finds it more economical and convenient for the parent to live in a home specializing in the care of the aged? Similarly, what is the result if, because of a chronic and disabling disease, the individual taxpayer finds it necessary to place his parent in a hospital for the chronically ill? It would appear that in both of the above instances, the taxpayer should come within the statutory definition of a head of household as there is a sufficient degree of permanency in these arrangements to qualify as a permanent place of abode.

The Internal Revenue Service, however, states in Revenue Ruling 57-307 that an individual taxpayer who pays the entire expenses of maintaining his mother in a home for elderly women may not on that basis alone be considered as a "head of household" for federal income tax purposes. *Your Federal Income Tax* (1960 edition for individuals) goes even further and categorically states that this is not considered as maintaining a home for her and the taxpayer may not claim to be a head of household upon the basis of supporting his mother. This ruling and its interpretation by the Service would seem to be discriminatory and not in conformance with the intent of the legislative enactment. Take the instance of an individual who, because of his mother's failing health, hires a companion or helper for her. Whether she resides with him or in a separate apartment, he can qualify as a head of a household. The individual, on the other hand, who either because of limited means or for other reasons enters his mother in an old age home where she will have companionship of people of her own age and can utilize the services of all the personnel of the home, cannot qualify, under the interpretation of the Service, as a head of a household.

In *W. J. Hein*, 28 TC 826 (1957), the Tax Court permitted a bachelor who maintained his sister in a mental institution to claim the head of household status even though there was little chance of a recovery and the illness was of long duration. The Court emphasized that the sister had been a

member of the household prior to her transfer to the institution and the household was open for her return. It therefore seems, under the rationale of that case, that an institutionalized or hospitalized parent who had previously been a member of the taxpayer's household, should qualify such taxpayer as a head of a household even though in fact the parent never leaves the home or hospital because of a terminal illness or physical disability. Revenue Ruling 57-307 does not refer to the added factor of a previously maintained household, and should not, therefore, prevent the favorable treatment where such added factor exists.

SPECIAL DUE DATE FOR FILING SHORT-PERIOD RETURNS

Normally, a Form 1120 for a short period occasioned by a change of accounting period is required to be filed by the fifteenth day of the third month following the close of the short period. However, because serious delays may be experienced in securing Internal Revenue Service permission to change the accounting period, it may be difficult, if not impossible, to file the short-period return by this date.

If permission to change the accounting period is not granted sufficiently in advance of the due date for the short-period return, an extension for filing may be required. However, a request for extension may present certain difficulties. First, the extension request may have to be submitted before permission to change the period has been granted, and it may not be certain that any short-period return will be required. In addition, a request for extension for filing would normally require a payment of part of the estimated tax for the short period.

In cases where serious delay may be anticipated, an alternative procedure is available which should be given consideration—to request the District Director to prescribe *a later due date* for the short-period return. This procedure is available to any type of taxpayer who must file such a return.

Regulations Section 1.607-1(b) provides:

(b) *Return for a short period.* In the case of a return with respect to tax under subtitle A for a short period (as defined in Section 443), the District Director may, upon a showing by the taxpayer of unusual circumstances, prescribe a time for filing the return for such period later than the time when such return would otherwise be due.

As an example of how this provision may be utilized, assume that a taxpayer has submitted a timely request for a change of period from a fiscal year to a calendar year. The change would require a return for a short-period ended December 31, 1960, which normally would be required to be filed by March 15, 1961. By early March 1961, the Service has not yet acted on the request and it is clear that even if permission were granted before March 15, the return could not be filed by that date. Accordingly, a letter may be sent to the District Director explaining these "unusual circumstances" and requesting that a due date of, say, 60 days after the granting of permission be prescribed for filing the short-period return. Of course, sufficient time should be allowed to permit the District Director to act on the request before the short-period return would normally be due.

An extended due date, if granted, would have a number of advantages. For example, it would appear that a corporate taxpayer:

1. on the new due date may file Form 7004 for an automatic extension of three months,

2. may pay the short-period tax in installments beginning with the new prescribed due date pursuant to Code Section 6152, and

3. would not be charged interest to the new due date, or after this date if

the short-period tax is paid half with a timely return (or Form 7004) and half three months later.

A special problem could arise if the National Office of the Service did not act on the period change request before the due date of a return for the old accounting period. In this case it would appear necessary to request an extension for filing this return, since one may be required for this former period if the request for change is not approved.

ORDINARY INCOME ON SALE OF SECTION 1231 ASSETS

Normally, a net gain realized on the sale of Section 1231 assets (i.e., property used in trade or business), if held for more than six months, will be treated as a long-term capital gain. Under certain circumstances, however, where the buyer and seller are related, such gains will be taxed as ordinary income.

A question recently submitted by a member of our Society will illustrate this point. Mr. J. owns an apartment house which, after 20 years, has a depreciated basis of $100,000. He proposes to sell this apartment house to the J. Corporation for its current market value of $300,000 in order to get a stepped-up basis for depreciation. The J. Corporation's stock is owned 50 percent by Mr. J. and 50 percent by his 30-year old son. The question posed is whether the $200,000 gain realized by Mr. J. on the sale could be treated by him as a capital gain.

In this particular case the answer is *yes;* the gain would be treated as a long-term capital gain under Section 1231. Although gains on the sales of depreciable assets are treated as ordinary income if sold or exchanged between specific related parties (Section 1239), the parties enumerated are restricted to (1) a husband and wife, or (2) an individual and a corporation more than 80 percent of the outstanding stock of which is owned by such individual, his spouse, and his *minor* children or grandchildren. Since Mr. J.'s son is an adult, Section 1239 does not apply and any gain would be treated as provided in Section 1231.

TREATMENT OF INSTALLMENT OBLIGATIONS IN SECTION 337 LIQUIDATIONS

Can a tax advantage be gained by a corporation or its stockholders where an election to liquidate has been made under Section 337, and the corporation proceeds to sell its assets on the installment basis?

Section 337 provides for non-recognition of gain or loss by the corporation upon the sale of its assets, including installment sales (except stock in trade unless sold to one person in one transaction). Section 453 further states that upon distribution of such installment obligations in the course of a Section 337 liquidation, no gain or loss shall be recognized to the corporation.

However, upon transfer by the distributing corporation of installment obligations to its stockholders, the installment obligations lose their special tax character. Although the corporate liquidation is treated as a capital transaction under Section 331(a)(1), the full fair market value of the installment obligations is required to be immediately included in the stockholders' capital gain computation.

There is therefore a distinct disadvantage in the corporation initially disposing of its assets on the installment basis. Stockholders may have to advance personal funds in payment of their current capital gains tax prior to the realization of cash through the maturing of the installment obligations. The non-recognition of gain to the corporation under Section 337 is thus irrelevant as far as the stockholders' tax liabilities are concerned.

Classified Section

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